Major Energy Users Inc.

28 May 2018

Mr Warwick Anderson
General Manager
Australian Energy Regulator
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By email to: rateofreturn@aer.gov.au

Dear Warwick

Estimating the allowed return on debt
Discussion paper

The Major Energy Users Inc (MEU) thanks the AER for providing the opportunity to provide input into the AER review of the rate of debt that will assist in the development of its revised guideline on setting the allowed rate of return (RoR) for regulated energy transport networks through the release of its Discussion paper May 2018.

The MEU notes that its Public Officer (Mr David Headberry) was a contributor to the AER Consumer Reference Group (CRG) report which provided consumers views on the various elements contributing to the overall rate of return guideline. The CRG noted in its report that some aspects of the rate of return on debt were not fully developed pending release of further information by the AER. The release of the discussion paper provides more information that the AER has acquired so this MEU response should be seen more as a continuation of the CRG response to the AER on the rate of return overall and more specifically the CRG commentary on the return on debt.

The MEU observes that the report from the CRG was quite concerned about the sources of information that the AER uses for various parts of its RoR guideline and the extent of the transfer of risks away from networks that are embedded in the rules. This MEU response to questions raised by the AER in its Discussion paper is influenced by the concerns expressed by the CRG.

One of the issues that the AER has failed to assess within its Discussion Paper is that there is now empirical evidence (from the Chairmont report) that the AER has

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allowed networks a considerable premium between the allowed cost of debt and the actual costs for debt incurred by the networks. This differential is observed in the work carried out for the AER by Chairmont, where over time the average premium allowed by the AER over the actual cost of debt incurred by the networks is some 70 basis points. Effectively consumers paid the networks ~70 bp more to the networks to acquire debt than the networks actually paid when averaged over the past 4 years; this is not efficient and is contrary to the national energy objectives.

The MEU notes that the regulatory approached used in Australia is one where there is an incentive on the network firms to reduce their costs and for these lower costs to be transferred to consumers over time while allowing the network firms to benefit from the lower costs in the short term – the theory of such an approach is that if a firm operating in the competitive environment is able to reduce its costs then it will be able in the short term to benefit from these lower costs before its competitors "catch up" such the firm loses its competitive advantage.

What is actually occurring is that the AER has allowed the networks to not only to have an unearned benefit at consumers' expense by allowing a cost of debt well in excess of the actual costs but for networks to fully retain this benefit. This is contrary to the concept of incentive regulation. The AER must look to rectify this anomaly.

It is apparent from figure 2 of the AER discussion paper, that the networks have remarkably maintained a fairly constant cost for debt (appearing to mostly lie within a band of 130 bp and 150 bp[1] relative to the 90 day bank bill swap rate - BBSW) over the past 4 years and have varied the term of debt to achieve this outcome; debt terms range between 5 years and 9 years with an average of about 7½ years. At the same time, AER figure 2 also highlights there is an inverse relationship between the AER allowed debt premium and the average term of debt.

The MEU considers that the AER has to implement an approach to setting the debt allowance that more reasonably matches the actual costs of debt, perhaps changing the settings (eg the term of debt, the credit rating and/or the source of independent data) to replicate the actual outcomes seen, as suggested by Chairmont in its report. The MEU notes that the AER attempts, at least in part, to replicate this advice in figure 4 of its discussion paper.

Credit rating

Firstly, the MEU points out that the credit rating that the AER should use for its guideline needs to be based on the credit rating of the Benchmark Efficient Entity (BEE). The CRG noted that there is currently no listed or unlisted network that perfectly matches the BEE in that all of them have other revenue streams not

[1] See graph 1 of the Chairmont report

related to their regulated assets which have, as the CRG noted, extensive protections from systematic risks and a certain and known future cashflow. This means that the credit rating noted for the entire entity reflects a credit rating that not only provides for risk of the sub-entity of the firm's activities that is related to what is equivalent to the BEE but to more risky activities which do not enjoy the benefits granted by the rules. This means that the credit rating identified for the firms are likely to understate the credit rating that the BEE would enjoy.

Secondly, the MEU points out that gearing of a firm has a significant impact on the credit rating of a firm. While the AER has provided a listing of the credit ratings for various firms that provide network services, the AER has not provided any analysis about the extent that gearing might have on the credit rating on each of the firms that it has based its assessment.

Thirdly, the MEU is aware that credit rating alone does not set the cost of debt, and firms (even countries) with the same credit rating do not have the same cost of debt. This raises the spectre that the AER sets a cost of debt based on a given credit rating but where the firm enjoys a lower cost of debt. This feature is discussed by the AER in chapter 9 of its paper where the AER uses a mix of two credit ratings (broad BBB and broad A) as a test to match the observed cost of debt[2]. While the MEU observes that the trace of the allowed debt moves downward closer by about ~10-15 bp to the observed average cost of debt, there is still the inverse relationship between debt term and the AER allowed rate, and still there is a significant premium between the new trace and the actual costs incurred by networks, implying that more is needed to develop a source of debt based on independent sources that does not result in consumers paying a premium..

The MEU does not consider that the observed data reflects the reality of the BEE and its low risk profile as the revealed data includes for more than the BEE activities. The MEU considers that rather than taking an average of the revealed data, the AER should recognise that the revealed data is conservative and needs to be adjusted to a higher level of credit rating.

In this regard, the MEU considers that the credit rating for the BEE should be A or A-, similar to that shown for ETSA and Ausnet which probably more closely reflect the BEE than other firms in the AER listing.

Third party yield provider

While the MEU supports the use of third party data to inform the AER about the cost of debt, it has a very real concern that using a third party data serries results in an allowance for the cost of debt that overstates the cost of debt that is actually achieved by the networks.

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[2] See AER discussion paper figure 4

The MEU considers that attempts to provide an independent source of data should not result in higher allowances than are efficient. The MEU points out that the work by Chairmont gives clear evidence that the use of the current data sources provide allowances for the cost of debt significantly higher than the cost incurred by the networks and so the AER needs to find an alternative source of data that more closely replicates the actual costs incurred by the networks.

The MEU is also concerned that the development of the various sources of data by the various providers is not transparent which leads to a concern that although the data is from a third party, there is no certainty that the data is appropriate or if the development is biased in some way. Without a clear and transparent methodology for the development of the outturn data, there is a concern that the data is not a fair representation of the cost of debt or that the extrapolation and interpolation carried out by the AER deliver sensible and appropriate outcomes.

While the AER seeks views on the appropriateness of the four different sources of data, it also highlights that all four series have failings to a greater or lesser extent. This implies that to overcome these shortcomings, some degree of combination of the data series is not only appropriate but necessary.

The MEU considers that the AER needs to carry out some testing of various combinations of the data series available and test these against the actual outturn assessments carried out by Chairmont in order to identify which grouping and weighting of the various series delivers the best match for the observed cost of debt.

The benchmark term of debt

The MEU considers that the AER assessment of the way each network addresses its debt is flawed in that there is an assumption that every network addresses its debt in the most efficient manner which will be in the "…long term interests of consumers …". In fact, each network will address its debt management in the interests of its shareholders and therefore will be unique to each network.

This is despite the observation in the Chairmont report which shows that generally the networks seek to hold the debt premium[3] relatively constant and to vary the term of debt to achieve this outcome. At the same time, the MEU notes there is an inverse relationship between the debt premium allowed by the AER and the term of debt used by the networks (see AER figure 2). This means that as debt terms become shorter in order to hold the cost of debt at a constant level, the AER still uses 10 year corporate bonds which deliver a significant increase in the allowance to the disadvantage of consumers and a significant windfall to the networks.

[3] Chairmont uses the 90 day BBSW rate as the variable to assess the debt premium

If the actual cost of debt is held relatively constant over time, the MEU considers that the term of the debt should not become the driving force in the setting of the allowance for the cost of debt with an observed debt premium being the key input.

The MEU considers that even if the average term of debt observed from the Chairmont report (ie ~7½ years) was used as the benchmark, the MEU is concerned that this will still result in the networks being provided with a debt allowance that exceeds their actual costs and so impose an unnecessary and inefficient cost on consumers.

The MEU notes that the AER and the Chairmont report is still using data from network firms that do not match the BEE as all networks have activities other than those that are addressed by the BEE. On the basis that these other activities do not reflect the unique status of the BEE (ie where many of the risks faced by the networks are removed by the rules), the cost of debt actually incurred by the networks would be higher than the costs incurred by the BEE, even if the BEE and the network shared the same benchmark credit rating[4].

The MEU considers that the AER needs to do more modelling than just what has been done based on 10 year debt terms. For example, the MEU considers that as well as modelling a mix of credit ratings (as for figure 4) the AER should carry out a similar exercise where the term of debt is varied to see if this results in an outcome which more closely matches the observed cost of debt.

The AER comments that they are aware that the network firms also access debt via banks as well as from bonds. Typically, bank debt has a shorter term than bonds, resulting is an average shorter term for all debt than is evidenced by bonds. With this in mind, the MEU considers that modelling a mix of debt terms (eg 4 year bonds as a surrogate for bank debt and 7 year bonds for longer term debt) might reveal a better match to the observed data than seen by mixing credit ratings.

An alternative approach

The AER implemented the trailing average approach to debt as this more closely replicated efficient debt management by the networks. Equally in the past, regulators used to identify a debt risk premium and apply this to setting the debt "on the day"

Debt is set annually and ultimately to be averaged over a 10 year window, so if the AER makes an underestimate for debt in one year, it has the ability to adjust the debt allowance the next year. Further, as the trailing average approach has been in place for most networks for some years, based on Chairmont's analysis, all of the networks should be in a position of over-recovery of the debt allowance.

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[4] As noted earlier, the MEU is aware that the costs of debt even for firms with the same credit rating vary based on other criteria assessed by a debt provider

This means the AER has the ability to now implement a new approach which does not greatly disadvantage networks in the short term and allows the AER to be a less conservative in setting a new approach to debt until the next rate of return review in 4 years time. With this in mind the MEU suggests the AER implement the following approach:

- The AER should estimate a debt risk premium based on the Chairmont analysis of (say) 150 bp
- The debt allowance for 2019 should be the 90 day BBSW plus the identified debt allowance
- Chairmont or the AER to review the 2018 actual debt data and incorporate it into the debt cost series (as it has already done for the years from 2014) and refine the debt risk premium to be applied for 2020.

As this approach uses aggregated data from a number of sources, it effectively provides an independent source of data, but data which is specifically related to the cost of debt applying to regulated networks and will still allow the networks seek improvement in their approach to the cost of debt.

Conclusions

The MEU is pleased that the AER has identified there is a need for the benefits of better financing practices by the networks to be shared with consumers[5] as this is a tenet of incentive regulation and is a sentiment not previously explicitly expressed by the AER. The MEU agrees with the AER that it has to ensure the benefits of efficient debt raising strategies flow through to consumers.

The MEU considers the AER Discussion paper raises as many questions as it answers, but an over-riding concern is that the data being used for the analysis results in outcomes that might not apply to the BEE, as the data is based on networks which carry out activities other than that assumed for the BEE and because the networks are required by their parent entities to undertake debt raising activities which reflect the needs and requirements of the parent (and its wider activities) rather than be efficient in terms of the needs of consumers that are serviced by the BEE.

The MEU considers the AER needs to do more modelling exercises to see if it can develop an approach to debt which can use third party data series but which results in a much closer match to the observed cost of debt. In this regard, the MEU considers the AER should examine the impacts of different debt terms as well as credit ratings to see if a neater match can be developed.

As a minimum, the MEU considers that the AER needs to carry out more modelling incorporating more variations (eg mixes of input data curves, credit

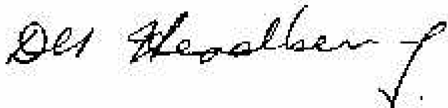
[5] See para 1, page 35 of the Discussion paper

ratings and debt terms) of likely inputs to see if there is a mix which results in a close comparison to the observed costs of debt.

If such a closer comparison is not possible, the MEU suggests that the AER have Chairmont implement an annual review of observed data to develop a reasonable debt risk premium above a variable benchmark (such as the 90 day BBSW used in the Chairmont analysis work) with the debt allowance applied to the latest value of the variable benchmark each year.

Should the AER require additional explanation as to the concerns expressed herein, please contact the undersigned.

Yours sincerely



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