31 May 2018

Mr Warwick Anderson
General Manager Networks Finance and Reporting
Australian Energy Regulator
GPO Box 3131
Canberra ACT 2601

Via email: rateofreturn@aer.gov.au

Dear Mr Anderson,

Submission to the AER's Discussion Paper on Estimating the Allowed Return on Debt from the Network Shareholder Group (NSG)

As a group, we have provided submissions on prior stages in the Rate of Return Guideline (**RORG**) review process. This submission presents our views on the AER's latest discussion paper on estimating the allowed cost of debt. As outlined in our previous submission, we support the AER's current methodology for estimating the cost of debt. That is, to estimate the efficient cost of a portfolio of 10-year debt for a benchmark efficient entity (**BEE**) with a credit rating of BBB+. This approach ensures that energy customers pay no more than the efficient cost of debt, remain insulated from increases in costs due to changes in ownership or poor financing decisions, and benefit from industry improvements in the benchmark efficient cost of debt in markets for debt.

Key Messages

- **We support the AER's current benchmark approach to estimating the efficient cost of debt. That is to estimate the trailing average cost of a portfolio of 10 year debt for a BEE with a credit rating of BBB+.**
- **We maintain that any changes to the current approach should meet a high threshold. In the absence of an improved and more accurate methodology, maintaining the current approach delivers greater stability and predictability.**
- **We do not consider that the information presented by the AER supports a change to the benchmark term of debt or the benchmark credit rating.**
- **Reliance on an industry specific index is a fundamental change to the AER's approach and inconsistent with an incremental review.**

We represent major investors in Australian electricity Network Service Providers (**NSPs**) and funds that are the custodians of the retirement and general savings for many millions of individual Australians – Spark Infrastructure, Hastings Funds Management, AustralianSuper, IFM Investors, Macquarie Infrastructure and Real Assets and AMP Capital (the Network Shareholder Group (**NSG**)).

Collectively, we have provided more than $12 billion in capital to the following electricity transmission and distribution network businesses: Ausgrid, Endeavour Energy and TransGrid in NSW; SAPN and ElectraNet in South Australia; and CitiPower and Powercor in Victoria.

As providers of long-term capital to support the provision of reliable energy network services to customers, we seek a regulatory regime that provides ongoing enduring confidence to invest efficiently through stability and transparency of process and outcomes, and importantly with confidence and certainty across multiple regulatory periods and resets. This ensures that risk remains consistent with investor expectations, reduces the cost of new capital to NSPs and delivers lower prices to customers.

The AER should continue to apply a high threshold for change and maintain reliance on the fundamental principle of the BEE. We do not consider that the information presented by the AER shows material or consistent movements in credit ratings or term of debt since the last RORG that would support a change to the benchmark assumptions, third party service providers or debt yield curves.

We note that the AER has sought actual debt information from the networks to serve as a 'sense check' to assist in determining whether the benchmarks remain appropriate. We consider this approach is a fundamental change to the adoption of a benchmark approach to estimating debt costs and is not consistent with an incremental review. The EICSI provides a simple 12-month rolling average of the credit spreads of all new debt issued by a sub-set of NSPs during a short period of time characterised by significant privatisation activity and growth in unregulated activities. It does not provide information on whether the benchmark term or credit rating is appropriate. An industry specific index is of little relevance in determining the benchmark efficient cost of debt for a BBB+ rated BEE seeking 10-year debt in the market for debt.

The benchmark approach to estimating debt based on the drivers of the cost of debt (term and credit rating) rather than the unique circumstances of an individual or group of NSPs remains appropriate. This approach ensures that customers pay no more than the efficient costs of debt and that investors bear the impacts of their decisions.

Please contact Sally McMahon, Economic Regulatory Advisor with Spark Infrastructure (phone: 0421 057 821) for further discussion or questions.

Yours sincerely,

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Attachment: Response to the AER's Discussion Paper on estimating the allowed return on debt

1. Overarching principles

The concept of the BEE is a critical element of the incentive framework and establishing the regulated ROR. The opportunity to outperform (or underperform) the benchmark and realise a ROR greater than the regulated ROR is a necessary component of attracting investment to the sector and encouraging NSPs and their owners to take a prudent level of risk, run the business as efficiently as possible and critically identify and foster innovation in future service delivery. Any movement away from a benchmark approach will not only risk an adverse change in behaviour but also break a fundamental principle behind the entire framework, introduce uncertainty and drive increases in the cost of capital. The approach to estimating the efficient debt costs based on the BEE remains appropriate.

The RORG should provide transparency, predictability, stability and replicability in estimates. Investors value these characteristics as this ensures access to low cost capital and lower prices to consumers. The opposite is true if the regime is subject to ad-hoc changes – unpredictability will see investors seeking higher risk premiums.

We urge the AER to assess any changes to the scheme against the framework set out in the national energy laws to ensure that any changes result in net benefits to energy customers over the long term. Further, we consider that the AER should apply a high threshold for change and ensure that any judgement and adjustments are transparent, and applied in a balanced and consistent manner. Consequential changes to related assumptions and parameters must be identified and taken in to account.

2. The NSG supports the current third-party data service providers

We are supportive of the AER's well-established approach to sourcing debt yield curves from third party data service providers as this supports transparency and independence. We are also generally supportive of broadening the pool of data providers provided data is credible, consistent and the series has been continuously available over a reasonable period of time. However, we do not consider that there is sufficient support for a change to the providers.

This approach ensures that efficient cost of debt is estimated with debt market outcomes and performance rather than the unique characteristics of an individual NSP. We support the use of factors adopted by the AER in assessing the quality of providers to use and the preference to minimise the need for adjustments. Where adjustments are required, they should be transparent, explained and consistently and symmetrically applied (free from bias).

3. The NSG does not support a fundamental change to the benchmark approach to estimating debt by introducing an NSP specific index

We note that the AER has sought actual debt information from the networks to serve as a 'sense check' to assist in determining whether the benchmarks remain appropriate. The analysis is presented in a report from Chairmont released with the AER's Discussion Paper. Chairmont has created an Energy Infrastructure Credit Spread Index (EICSI)[1]. The report outlines that the index was developed to assess the actual debt costs of underlying businesses without modelling adjustments to target a theoretical benchmark.

We consider this approach is a fundamental change to the adoption of a benchmark approach to estimating debt costs. The EICSI provides a simple 12-month rolling average of the credit spreads of all new debt issued by a sub-set of NSPs during a short period of time characterised by significant privatisation activity and growth in unregulated services. It does not provide information on the appropriate benchmark term or credit rating. An energy

[1] Chairmont Consulting, Aggregation of Return on Debt Data, 28 April 2018, p. 3.

infrastructure specific index is of little relevance in determining the benchmark efficient cost of debt for a BBB+ rated BEE seeking 10-year debt in the market for debt.

However, if the analysis is to be relied on for any purpose, the EICSI must be subject to further specification and testing and the provider of the index must be assessed against the criteria applied to the other third-party service providers. The EICSI shows lower margins during the relatively short period from 2014 to 2017 than that measured by the AER for 10 year broad-BBB debt and less volatility than the credit spread of the third-party service providers relied on by the AER to date.

The report emphasises that lower actual margins do not necessarily indicate that the AER's cost of debt methodology is inappropriate and that the observed stability in debt costs can be largely explained by variations to the term to maturity of debt raised by the industry. That is, when spreads are high, the NSPs raised shorter term debt and when spreads were low, the NSPs raised longer term debt. This is consistent with efficient behaviour expected of a BEE.

We do not consider that the information in the Chairmont report provides sufficiently robust support for a change in the benchmarks. This is because differences between an energy infrastructure specific index and the index for 10 year debt for a BBB+ rated BEE that might be regulated or unregulated are expected. For example:

- There are no pure-play NSPs to include in an NSP index.
- The differences between the EICSI and market credit spreads are within a range that is justified by the individual circumstances of the NSPs and do not differ materially to the benchmark assumptions.
- The time period is too short and includes significant privatisation activity that is likely to be characterised by short term debt raising of significant size.
- Funding of unregulated services that are likely to be higher risk and drive a shorter tenor.
- Ratings notch increases from implied support/shareholder halo (which are driving up pricing improvements).

We also highlight the findings within the report that suggest that the index is experimental at this stage:

- The report acknowledges that a more thorough examination of factors that explain the observed lower margins, such as taking refinancing risk, good judgement of broad market cycles, debt terms and amounts forced on them by the market, in part dependent on investor and lender appetite are outside the scope of the report and that there may be potential to create an adjusted EICSI that might be more useful.
- The report identifies several shortcomings in the nature of the index and comparability of the index, which need to be taken into account in interpreting the results. This includes the inclusions and exclusions as well as significant variations in composition.
- The report outlines that improvements could be made to the EICSI to enable more useful comparisons. For example, adjustment in weightings for size, term, ratings and price data clustering. The report also recognises that there is no uncontroversial method to weight reported spreads and discusses the need, impact and merits of alternative approaches.

The benchmark approach to estimating debt based on the drivers of the cost of debt (term and credit rating) rather than the unique circumstances of an individual or group of NSPs remains appropriate. This approach ensures that customers pay no more than the efficient costs of debt and that investors bear the impacts of their decisions.

4. The NSG supports a benchmark debt term of 10 years and credit rating of BBB+

We support retaining the current benchmark assumptions for term of debt (10 years) and credit rating (BBB+). There is no evidence of a clear or material change in the credit rating or financing practices of the BEE and, as a result, a change will not materially improve on the current approach but will simply increase uncertainty and reduce stability and predictability in the process and outcomes.

A 10 year term remains appropriate for a BEE, given the long-term nature of network assets. This is also consistent with the financing practices of many NSPs. While some NSPs opt to raise short-term debt, this may reflect

preferences at a particular point in time and the risk profile of ultimate owners, short term financing structures adopted in connection with recent sale processes, and other business-specific circumstances (such as the risk profile of unregulated business activities). A credit rating of BBB+ remains consistent with the ratings available for entities with interests in NSPs, notwithstanding that often these ratings are likely to be higher than a standalone NSP could achieve due to the acknowledgement in the ratings of implied parental support and the inclusion of other non-regulated activities often co-mingled in the financing vehicle for a NSP business.

We also consider that the following issues are likely to arise from a change to benchmark assumptions:

- A change in the term of debt will require changes to other rate of return parameters affected by the change (such as a higher cost of equity reflecting the increased risk).
- A change in the term of debt will introduce significant additional transitional issues at a time when many businesses are part-way through the 10-year transition period to the trailing average cost of debt methodology.
- Together, these changes will be a catalyst for NSPs to adjust capital structures to minimise exposure to future changes in market condition and impact on the risk profile of the NSP, which may impact on other ROR parameters.

5. The NSG supports continuing use of the broad – BBB curve

Investors recognise the conundrum of adopting the broad-BBB curve to estimate debt costs for a BBB+ rated BEE. However, we do not consider that adopting an arbitrary weighting to a broad-A curve is likely to resolve the issue. Indeed, this may undercompensate the BEE by giving too much weight to A and A+ rated debt issuers. The observed credit ratings presented in the AER's Table 4 include ratings of BBB and A-, but no rating of A or A+ and the median rating is between BBB and BBB+. However, as outlined earlier, we consider the observed ratings are likely to overestimate the credit ratings of the NSP as they are impacted by implied parental support which should not apply to the BEE. In the absence of an accepted superior methodology, or demonstrable improvement in accuracy, we consider that maintaining the current approach is likely to deliver the greatest stability and predictability and less likely to increase uncertainty and risk.

6. Response to AER Questions

1. Does the evidence support continuation of a BBB+ credit rating or a change? If it supports a change, what should the benchmark credit rating be?

The evidence does not support a change to the benchmark credit rating. There is no material change in ratings for the entities reported by the AER since the last RORG. The median credit rating ranges between BBB and BBB+ over the time period analysed. The threshold for a change to the benchmark should be high and based on a material change and robust evidence.

2. What are your views on the relevance of market expertise of the above providers with respect to estimating corporate debt yield curves for our purposes?

All four providers have a strong reputation in the market and none warrant exclusion solely on the basis of their (lack of) relevant expertise.

3. Having regard to the available evidence, are any of the curves clearly superior to the other curves in terms of their overall fitness for purpose?

We agree with the AER that none of the curves are clearly superior. We consider that there should be a high threshold for change to the current service provider and yield curves.

4. How should we consider the impact of adjustments to curves away from their published form when deciding on the curves to use in our benchmark?

We agree with the AER's preference for curves that require fewer adjustments from their published form for use in the benchmark. Where adjustments are made, they should be transparent, explained and applied consistently and symmetrically.

5. How should we consider the impact of curve availability over time when deciding on the curves to use in our benchmark?

We agree with the AER's preference for curves that have been published continuously over a longer time series.

6. How should we have regard to curve outcomes over time when deciding on the curves to use in our benchmark?

We agree with the AER's approach to apply a low weight to curve outcomes, as there is no 'true' 10 year, BBB+ return on debt directly available and therefore no reliable way to validate against different sources.

7. In your view, does this evidence support a change to the current benchmark term of debt being 10 years? In answering this question, please address:
   a) The impact of a change on term to the trailing average approach, including whether this change would have long term or transient impacts
   b) The implications of such a change for regulatory certainty given the multiple-period commitment that may be implicit in the transition to the trailing average
   c) The appropriate way to establish a benchmark if there is evidence of multiple distinct term issuing practices amongst networks?
   d) The longer term data on benchmark term to maturity as estimated in previous rate of return review processes.

The evidence does not support a change to the current benchmark term of 10 years and there should be a high threshold for change. In addition, any change would adversely affect network operators who have already-established debt positions and are part way through the transition.

a) Any change would require an adjustment to the transition to the trailing average approach, as well as the trailing average approach itself.
b) Any change would weaken regulatory certainty.
c) The current approach of adopting a 10 year term benchmark is appropriate.
d) There is no clear material change in debt tenor since the last RORG to warrant a change.

8. How should we implement the benchmark credit rating? In particular, what do you consider is the appropriate broad-curve rating to use?

We support the AER current approach to implementing the benchmark credit rating and adopting the broad-BBB curve. The evidence does not justify any change to the AER's current approach.