Energy Network Debt Data

AER Draft Working Paper

Stakeholder Forum, 29 July 2020

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Outline of presentation

1. Introduction
2. Energy Networks Debt Costs Index
   a. Methodological issues
   b. Application
3. Term of Debt
4. Credit Rating
5. The way forward

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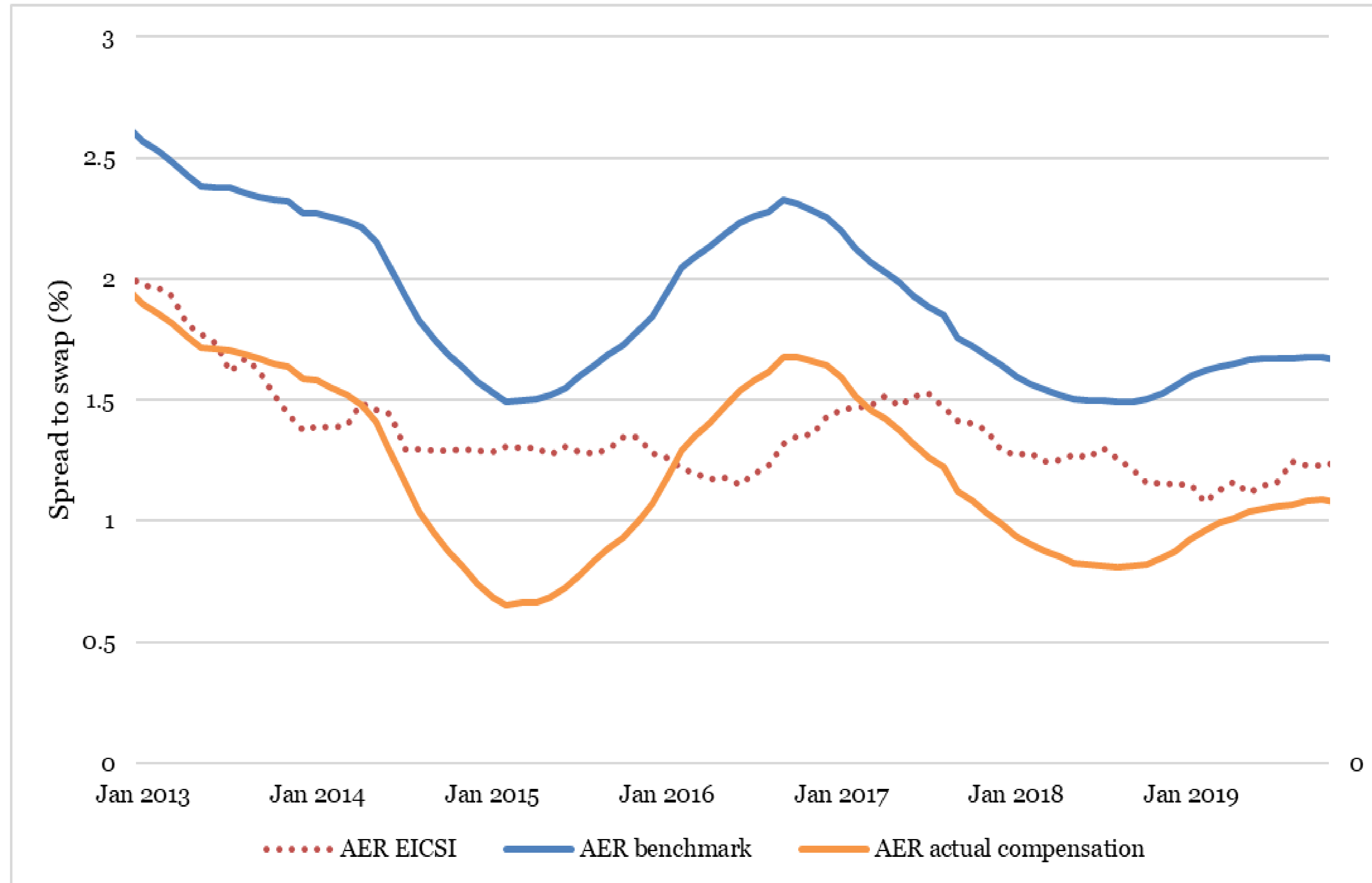
Prices and debt compensation have been below efficient levels



As forecast and outturn inflation have not matched, funding for debt has generally been below actual costs as per the AER's EICSI

- Prices have been below efficient levels

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Customers benefit when debt allowance set at efficient levels

- Interest on debt makes up a material part (approx. 30%) of prices.

- Essential that this is set at the right level to ensure customers do not over pay **and** networks are able to fund efficient interest costs.
  - **If too high** – increases customer prices above necessary levels.
  - **If too low** – could jeopardise investment grade credit ratings, increasing customer prices above necessary levels over the longer term.

Credit rating	Additional annual debt cost compared to BBB+ benchmark ($)	Additional annual cost per customer ($)
BBB	+143m	14.3
BBB-	+ 285m	28.5
BB+	+ 570m	57.0

Note – based on $95bn RAB in 2019

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Energy Networks Debt Costs Index

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Two Ways to Examine Network Debt Costs

1. What are networks' costs are when they issue debt like the benchmark?

Implications

a. Exclude debts that are different to the benchmark

2. What are networks' total costs, including costs of any debt which is different to the benchmark?

Implications

a) Weight debt costs by their importance in funding the RAB
b) Don't exclude any debt used to fund the RAB.

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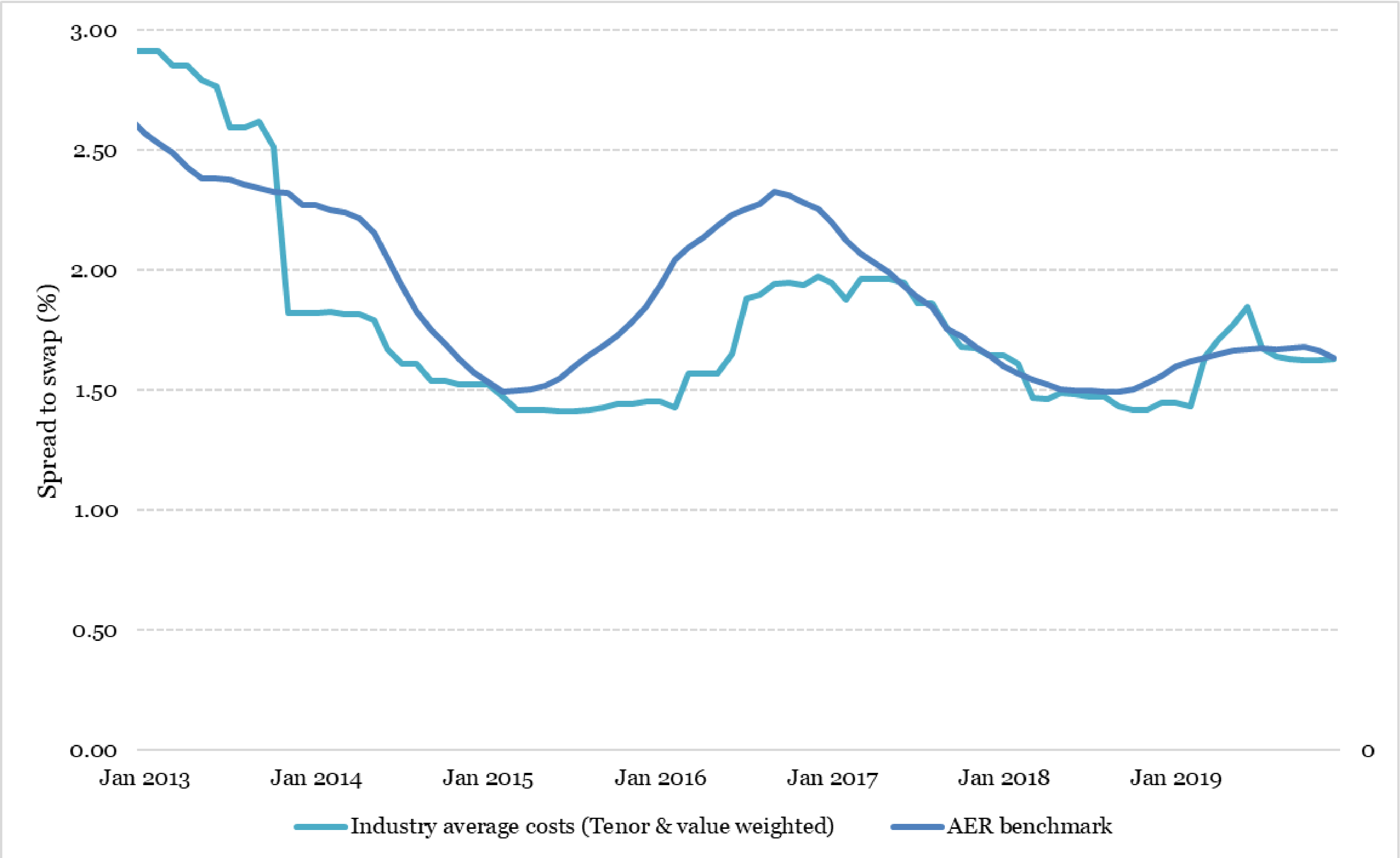
AER's benchmark reflects network costs for debt like the benchmark



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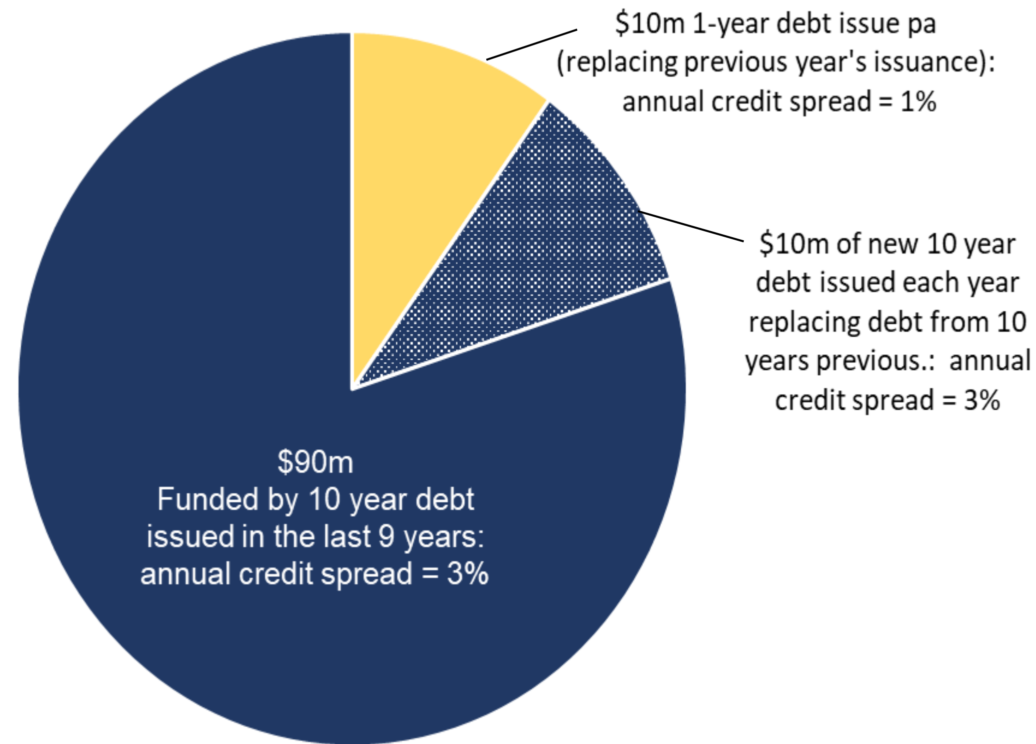
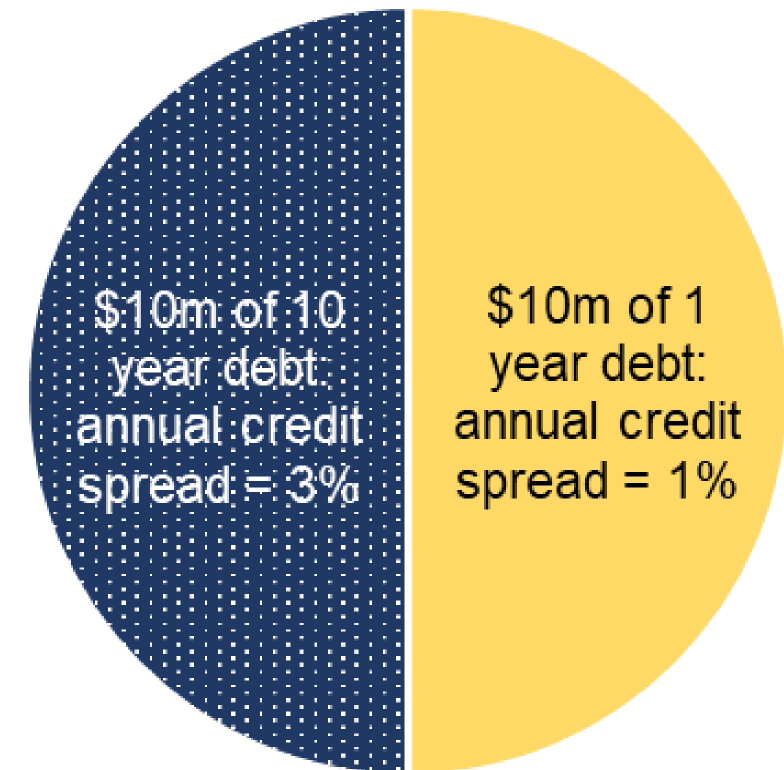
Need to Weight by Tenor or Short Term Debt is Over-represented





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It is unclear why some debt (and not others) is excluded from AER EICSI

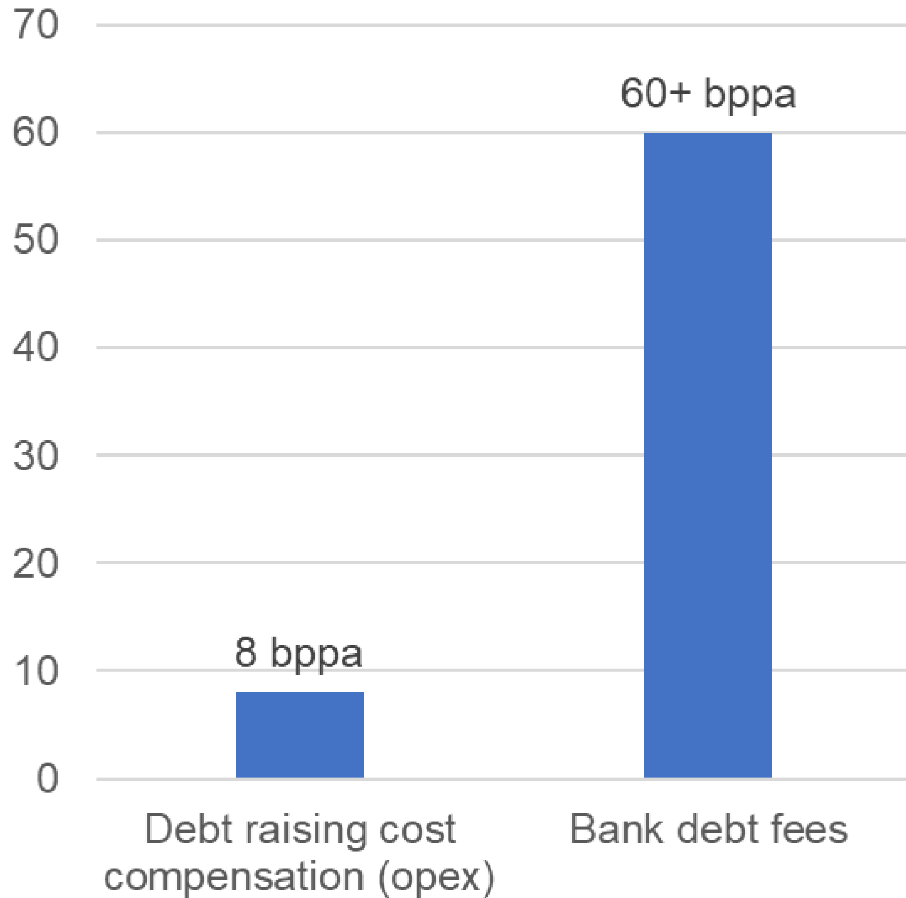
Callable bonds are **excluded** but callable bank debt **included**.

Some short-term bank debt is **excluded** but other short-term bank debt **included.**

Some non-RAB related debts **excluded** (e.g., fleet lease) but other non-RAB related debts **included** (e.g., line of credit)

If EICSI meant to reflect networks' **actual RAB debt issuance costs**, need to include **all actual RAB debt issuances**

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 not short-term debt used for working capital/ liquidity)
- But need 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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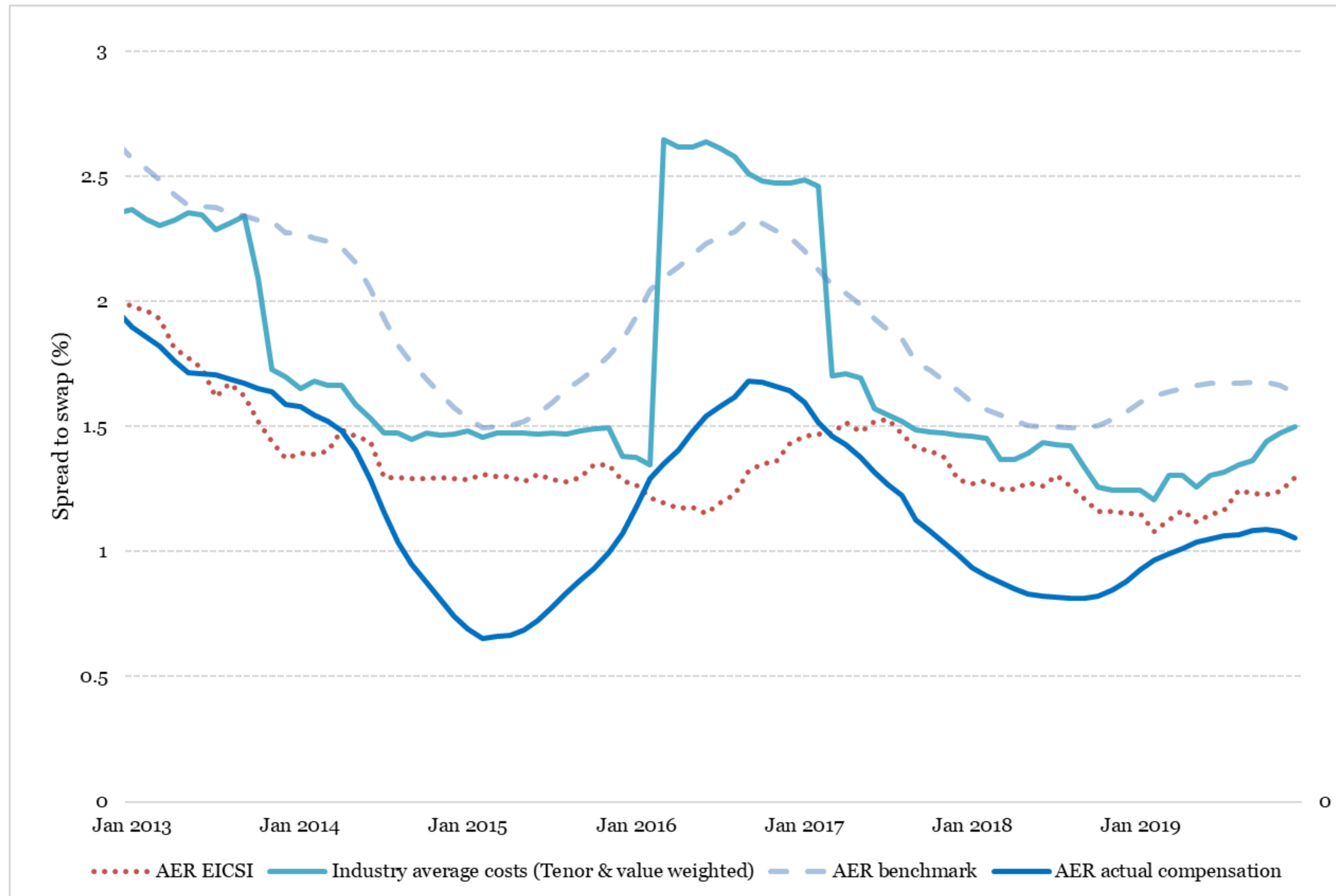
Network debt costs at issuance

All debts – no exclusions, (even for working capital), all lines of credit assumed to be used, no attempt to factor in higher bppa fees from short term bank debt



Costs consistent with benchmark and uniformly higher than actual compensation.

Moreover, representation is conservative. Ideally need to also:

- Exclude debt not used to finance the RAB (i.e., short term lines of credit used for working capital);
- Where bank debts are included, the higher funding costs (e.g., associated with commitment fees) should be included.

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Risks associated with the AER use of the EICSI

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Placing weight on the EICSI is undesirable

EICSI is in its infancy

- Methodological refinements needed
- Criteria for exclusions are unclear and unexplained
- Interactions with debt raising cost opex have not been considered

Case for change?

- Current benchmarks are performing well
- Step increase in complexity
- Erosion in transparency

Would Increase Financing Risk

- Impossible to match debt costs and allowance
  - Networks currently make financial decisions in debt averaging periods in real time based on debt benchmarks available daily
  - Index does not reflect 'prevailing' cost of debt – market can move in a year
- Erosion in transparency

Distorts Incentives, Increasing Prices

- Placing weight on the EICSI could encourage networks to higher spread strategies, increasing prices
- Financing costs unlike opex: higher financing costs also = lower risk
- Therefore networks would benefit from lower risk while only bearing part of the cost of the deviation

Term of debt

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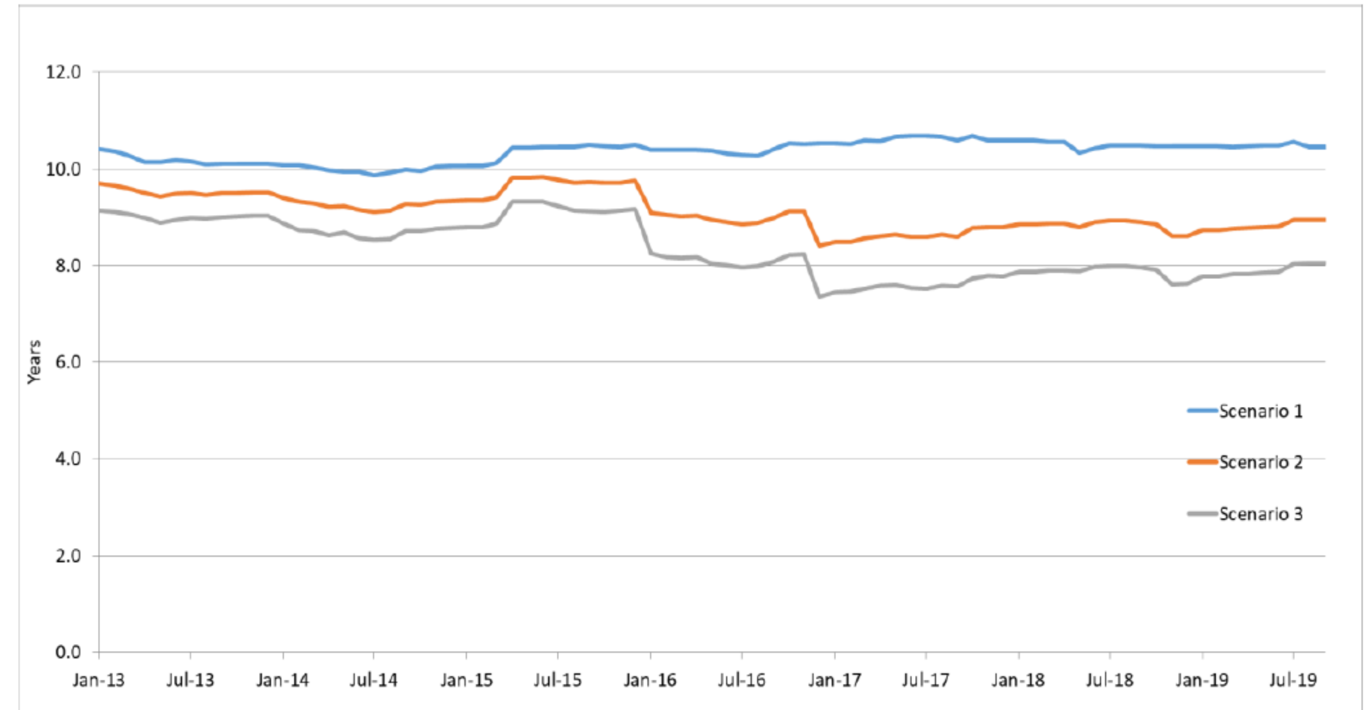
Benchmark term of debt remains 10 years

- Support the Chairmont analysis verifying a 10 year term accurately reflects average debt issuance for NSPs.
    - Uses weighted average data, as recommended by the ENA

- Transition to a 10-year trailing average remains underway

- Impacts of COVID-19 may be seen in next year's data update on benchmark term
    - Market uncertainty discourages long-term debt issuances

Figure 2 Weighted average term to maturity at issuance for the EICSI dataset – comparison of drawdown sensitivities



Source: AER analysis, based on method in Chairmont, *Aggregation of Debt Data for Portfolio Term to Maturity*, June 2019.

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Credit rating

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Benchmark Credit Rating must be Congruent with Expected Outcomes delivered by the Regime

- Today's credit rating data is irrelevant to the 2022 Rate of Return Instrument:
  - Does not incorporate financial impacts of the 2028 RORI, the low bond environment, or the material difference between the AER and the market's expectation of inflation
  - Recent AER determinations embedding negative profits do not support investment grade credit ratings such that current ratings are not sustainable
- Changes to the benchmark credit rating should be considered as part of the AER's 'Rate of return and cashflow in low return conditions' Working Paper
  - Must have regard to **forward-looking, financeability analysis**

» Unclear why AER's analysis (below) is based on:

  » A 19 month period

  » The median rating (A-), not the mean (BBB+)

  » A per issue, not per issuer, basis

  » Disaggregates related entities

» This include impacts of incentive scheme revenue and parental support – not just AER decision revenues

Table 2 Comparison of rating of issued debt before and after 1 Jan 2018

	Overall	2013–17	2018–Aug 2019
Mean	3.14	3.01	3.44
Median	3 [BBB+]	3 [BBB+]	4 [A-]
Standard Deviation	0.90	0.86	0.93
Range	3.5	2.5	3.5

The way forward

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The way forward

- The AER's EICSI is complex and in its infancy
  - Networks will continue to work with the AER on refining this
- Placing weight on this in regulatory decisions is unnecessary and would increase risk
- Average actual term of debt continues to reflect the 10 year benchmark
- Benchmark credit rating needs to have regard to **forward-looking financeability analysis** given true impact of recent AER decisions and market conditions are **not observable in today's data**

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