31 May 2018

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

Via: rateofreturn@aer.gov.au

Dear Warwick

AER Discussion Paper –Estimating the allowed return on debt

SA Power Networks, Australian Gas Infrastructure Group, CitiPower, United Energy and Powercor (**the Businesses**) are pleased to provide this submission in response to AER's Discussion Paper- Estimating the allowed return on debt (**Discussion Paper**).

The Businesses note their input into the submission provided by Energy Networks Australia in response to the Discussion Paper and endorse the positions in that submission, including the responses to the AER's list of questions. This submission highlights matters arising from the Discussion Paper that we consider are particularly important in moving towards a draft Rate of Return Guideline.

Incremental approach

The Businesses continue to support an incremental approach to the Guideline review. This is particularly important when considering the methodology to estimating the return on debt, given most networks are already part way through the transition to the trailing average approach adopted in the 2013 Guideline. Any change to the transitional methodology, or the key assumptions underpinning it, would result in significant uncertainty, disruption and increased costs as networks try to adapt debt management practices in response to a change of approach.

As the Discussion Paper notes, most stakeholders are supportive of maintaining substantial parts of the current return on debt approach and we welcome the AER's focus on the choice of third party data provider and the choice of appropriate debt series.

In considering those two issues, the threshold for any material changes from the current Guideline approach should be considered to be high given the need to ensure regulatory certainty and stability in order to further the national electricity objective (**NEO**) and the national gas objective (**NGO**). Any change should only be made if there is clear evidence that the change will better advance the NEO/NGO.

Third party yield curve provider

The current approach arising from the 2013 Guideline is to estimate the return on debt based on a simple average of the 10 year yield on broad BBB rated data published by the RBA and the 10 year yield on BBB rated data published by the Bloomberg Valuation Service.

Since the 2013 Guideline, two new data providers have commenced publishing yield curves, Thomson Reuters and Standard & Poor's (**S&P**). The Businesses agree that there is benefit in using as much data and information as possible to estimate parameters, but only where the data is reliable and fit for purpose.

While all four of the possible data sources have limitations, the Thomson Reuters and S&P curves have material limitations that, at the present time, make them inappropriate for use in estimating the return on debt. In particular:

- As noted in the Discussion Paper, the Thomson Reuters curve is only available intermittently and this may be a consequence of the curve fitting methodology used.
- The S&P curve is relatively new and its reliability is therefore difficult to assess. As the Discussion Paper notes, the credit spreads observed using the S&P curve to date have been materially different to that implied by the RBA and Bloomberg curves.
- S&P does not publish information about its methodology or the data it uses, making it difficult to understand and identify why there are such material differences in its results.
- The S&P index also includes bonds issued by foreign firms in Australia, which is inconsistent with the AER's definition of the benchmark efficient entity as an Australian firm.

In contrast, the RBA and Bloomberg curves are well understood and accepted by stakeholders and produce results which are broadly consistent. These two data sources also better match the characteristics of debt issued by the benchmark efficient entity.

The Businesses submit that at this time the Thomson Reuters and S&P curves are not fit for purpose or appropriate to use to estimate the return on debt, and the current approach using a simple average of the yields estimated by reference to the RBA and Bloomberg curves should be maintained. Further consideration should be given to the Thomson Reuters and S&P curves (and any other additional data sources that become available) at the next guideline review when further information about the data and the performance of the indices may be available.

The Chairmont analysis

As part of the Discussion Paper the AER published a report from Chairmont which considered actual debt information provided by service providers to the AER, created an Energy Infrastructure Credit Spread Index (EICSI) and compared that index with the broad BBB corporate credit spreads used under the AER's approach. Based on the Chairmont report, the AER observes there are differences in the AER approach and the EICSI and raises a number of questions about the appropriateness of the current benchmark term of debt of 10 years.

As set out in detail in the Energy Networks Australia submission, the Chairmont analysis has been carefully considered by our consultants and we are concerned that it is subject to material limitations. We would like to work with the AER in the lead up to the draft Guideline to ensure the Chairmont analysis is fully understood and considered. In our submission, as we presently understand the analysis, it does not provide sufficient evidence to support a change to the benchmark term of 10 years, including because:

- The Chairmont analysis excludes callable and subordinated debt. This appears to be a significant driver of the difference between the EICSI and the AER's benchmark approach. This debt is used to manage credit rating metrics on other debt and should be included in any analysis.
- The Chairmont analysis is undertaken over a very short timeframe between 2013 and 2017 (half the life of a 10 year debt instrument) and does not include the most up to date information from 2018.
- The period covered by the Chairmont analysis includes the period when there were a number of large privatisations of networks (NSW electricity networks) and changes in network ownership (DUET) which resulted in debt issuances which have a material impact on the results. As the Energy Networks Australia submission explains, these issuances are likely skewing the results and resulting in a shorter average term of debt, and consequently, a lower average tenor than would be the case once the transition period is complete.
- Chairmont has used an equal weighting for short term and long term debt issuances. Short term debt is refinanced more often and should be given appropriate weight. The Businesses support the weighting approached suggested in the Energy Networks Australia submission.

These concerns mean that the Chairmont analysis should not be relied upon as clear evidence that the current benchmark term of debt of 10 years is no longer appropriate, or to support any other change to the cost of debt methodology. Given networks are part way through a transition to a trailing average approach, a fundamental characteristic of which is the assumption of a 10 year term of debt, there would need to be very strong evidence that the term of debt assumption was no longer appropriate and that a change to that assumption would better contribute to the achievement of the NEO/NGO. The analysis does not currently give rise to that level of confidence and the current 10 year term should be maintained.

Even putting aside the concerns raised above, the Chairmont analysis does not indicate anything surprising or any necessary divergence between the actual and benchmark term of debt. Many networks had their averaging periods when the RBA/Bloomberg indices were showing very low yields (see Figure 2 of the AER issues paper). The AER's current transition approach weights the initial debt observations heavily, with the weight decreasing as the transition progresses. Networks experiencing low interest rates at the time when their transition commenced would, as rates increased, likely have reacted to keep their overall cost of debt within the regulatory allowance where possible. This requires issuing shorter term debt; as the Chairmont analysis shows they in fact did. This, in turn, would result in lower actual debt costs in the EICSI.

However, this is a temporary response associated with the transition to the trailing average approach under the 2103 Guideline and the timing of a number of decisions. As networks move to a full trailing average, all years are equally weighted and there is therefore no need to reduce tenor to match the regulatory allowance in a given year. This temporary response and its impact on the EICSI needs to be taken into account when considering the Chairmont analysis.

Please contact Mark De Villiers on (03) 9683 4907 if you would like to discuss this submission further.

Yours sincerely

Patrick Makinson
Company Secretary

Renate Vogt
General Manager Regulation

Craig de Laine
General Manager Strategy and Regulation