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Locked Bag 14051
Melbourne City Mail Centre
Victoria 8001 Australia
T: 1300 360 795
www.ausnetservices.com.au

General Manager – Network Finance and Reporting
Australian Energy Regulator
Canberra ACT 2602

Dear

Energy Network Debt Data – Draft Working Paper

AusNet Services welcomes the opportunity to comment on the AER's draft Working Paper. We support the AER's publication of a number of Working Papers in the lead up to the active stage of the 2022 Rate of Return Instrument (**RORI**) review, which will ensure there is adequate time to deeply consider key issues.

Use of Network Debt Data

In 2018, the AER began collecting actual network debt data back to 2013, and first constructed its debt index (Energy Infrastructure Credit Spread Index, or EICSI) at a late stage of the 2018 RORI review. Interpreting and analysing debt data is a very complex exercise – networks have different debt management practices involving many types of financial instruments. This exercise is still in its infancy.

Today, the index still contains serious methodological flaws which were raised by industry in the 2018 RORI process but have not yet been addressed. These relate to:

- The material over-weighting of short-term debt;
- Unclear criteria for inclusions and exclusions of particular debt instruments; and
- Lack of consideration of bank debt fees. Further detail is provided in the ENA's submission.

AusNet Services will continue to work constructively with the AER in providing and interpreting its debt data so the AER can improve the accuracy of its index over time. If appropriately constructed, the AER's index may play a useful role for monitoring purposes. However, it is neither required nor appropriate for this to be used determinatively in setting the debt allowance, for the reasons set out below.

The Case for Change

So far the AER has not laid out a case for change. Applying the EICSI to set the debt allowance causes many serious theoretical and practical implementation issues, which are explained below. Given there is no case for change, dealing with these issues are more appropriately addressed while limiting the EICSI's role to monitoring alone.

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Application of the Index

There are many benefits in continuing the current practice of divorcing the debt allowance from actual debt costs. Setting debt compensation based on third party indices is working well.

Analysis of industry debt data shows that when networks issue debt with characteristics like the benchmark, the current Bloomberg, RBA and Thompson Reuters indices closely match network debt issuance costs. This implies that, if the EICSI is lower than the benchmark, some networks have departed from benchmark financing practices to issue lower spread debt. However, given the strong link between debt costs and financing risk borne, these networks bear an increased, and uncompensated, level of risk compared to the benchmark approach. Therefore, this does not automatically mean that this reflects efficient practice, nor should the benchmark be reset to reflect this increased level of risk. A benchmark reflecting much shorter-term debt issuances, for example, would increase the volatility of prices as larger proportions of debt would be reset more frequently, including during periods of financial crisis. This price volatility would then be borne by customers.

For example, AusNet Services' debt management practices line up with the AER's benchmark. We have a staggered portfolio of long-term bonds, with a targeted tenor of 10 years. Not all networks finance in this way. As mentioned above, where networks depart from the AER's benchmark – for example, by raising debt with a tenor of less than 10 years – this will reduce spreads (and therefore the AER's EISCI). The current EISCI is an average of the cost of **actual**, not **benchmark,** debt management practices. Actual practices are relevant in informing the benchmark over time. However, if the EISCI is used to set the benchmark cost of debt, actual practice that is different from the benchmark will impact debt compensation for networks, like AusNet Services, who do finance consistent with the benchmark. This is not appropriate.

AusNet Services attempts to match its debt costs to the regulatory debt allowance by aligning debt issuances and/or swap transactions with its debt averaging periods. If the EISCI is given any weight in setting the debt allowance, given it is a 12 month rolling average, we will no longer be able to closely match actual debt costs and the regulatory debt allowance. The debt market can move significantly in 12 months and it is impossible to pick a point to issue debt or enter into swaps which will exactly match the 'average' that will captured by the EISCI.

In considering whether to apply the EISCI to set the debt allowance, the AER's starting point appears to be that debt costs should be benchmarked like opex – i.e. compensation should be based on revealed costs. However, there is a much stronger trade-off between cost and risk for debt than for opex – that is, debt costs incurred are essentially the market price for a given level of financing risk. If debt costs reduce, this is because a network is taking on more financing risk; that is, the risk that when shorter term debt is refinanced, funding costs are materially higher or financial markets difficult to access, such as has been experienced during the pandemic or GFC.

This direct trade-off between costs and risk means that it should not be assumed that costs to customers will be lower if the EISCI is used to set the debt allowance. Instead, at the margin, this could create a stronger incentive than under the current approach to issue higher spread debt, lowering risk. This is because individual networks benefit fully from the reduction in risk, but do not wear the full cost – as the higher cost debt issuance will be reflected in the EISCI and, therefore, the debt allowance provided to the network.

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Benchmark Term

AusNet Services supports the Chairmont analysis which concludes that the benchmark term for industry debt should remain close to 10 years. There is no case for change.

In its 2013 Rate of Return Guideline the AER stated:

> *'.., in moving to a trailing average approach we consider that we are committing to a debt term for the period nominated. To change the benchmark debt term in response to updated portfolio information would not be conducive to regulatory stability. In light of this, in order to ensure that the benchmark efficient entity is able to recover its efficient financing costs consistent with the allowed rate of return objective, we propose to use a 10 year debt term for the purposes of estimating the return on debt and for setting the period of the trailing average.'*[1]

AusNet Services' transmission network was the most recent network in the NEM to commence the transition to the trailing average approach – from 1 April 2017. It will be in a transition phase until 31 March 2027 and has arranged its debt financing accordingly.

As per the AER's commitment above, it is important for regulatory stability that the benchmark term of debt is not changed in the 2022 RORI.

The benchmark term of debt is a matter that should be settled early on in the 2022 RORI process, for the following reasons:

- The AER has previously committed to retaining the benchmark debt term of 10 years while networks are transitioning to the trailing average debt approach;
- Chairmont's most recent analysis has shown that actual debt practices support a 10-year benchmark term; and
- Data showing the average term of issuance of industry debt collated in 2020 should be treated with caution. The COVID-19 pandemic created market uncertainty, which discourages long-term debt issuances. Any observed decline in the average term of debt issuances seen in the 2020 data would be highly unlikely to be due to a genuine shift in underlying efficient debt management practices.

Credit Rating

We encourage the AER to consider the appropriate benchmark credit rating in its forthcoming working paper on financeability. The benchmark credit rating set in the 2022 RORI needs to be congruent with the cash flows provided by that instrument. 2019 credit rating data is irrelevant to this assessment as it does not reflect:

- The application of the 2018 RORI to many networks in the AER's sample (including the Victorian and South Australian distributors); and
- The cashflow impact of regulatory determinations being made in the current low return conditions. For example, the recent SA and QLD distribution determinations do not deliver benchmark return on capital allowances that are sufficient to cover the AER's

[1] AusNet Services, *Better Regulation – Explanatory Statement, Rate of Return Guideline – December 2013*

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estimate of the benchmark efficient interest costs. It is unclear how investment-grade credit ratings can be sustained if these outcomes are embedded across industry.

Consistency in Decision Making

Any changes to setting regulatory allowances must be based on strong evidence that current approaches are no longer fit-for-purpose – that is, the case for change must be clearly established before alternatives are considered.

The AER is currently reviewing the regulatory treatment of inflation and the approach to setting the debt allowance.

It is notable that in the inflation review, despite compelling evidence that the AER's approach to setting expected inflation – which assumes inflation returns to 2.5% within two years regardless of market and RBA expectations – is flawed, the AER has reiterated there is a very 'high bar' for any change to occur.

However, in the debt working paper review, numerous extreme options for change are being considered (including the direct application of a fundamentally flawed index to set actual debt costs), despite no case for change being set out.

Please contact [redacted], Manager Economic Regulation on [redacted], with any questions in relation to this submission.

Sincerely,

[redacted]
General Manager Regulation
AusNet Services