14 August 2020

Ms Clare Savage
Chair,
Australian Energy Regulator

Sent via email

Dear Ms Savage,

AER Energy Network Debt Data - Draft Working Paper

Energy Networks Australia (ENA) welcomes the opportunity to respond to the Australian Energy Regulator's (AER) draft working paper on *Energy Network Debt Data*. We look forward to further constructive engagement with stakeholders throughout the remainder of this important process.

ENA's view is that the AER's current approach for setting the return on debt allowance is working well and remains fit for purpose. Analysis of industry debt data shows that the current approach does align with actual costs where networks issue debt instruments that reflect benchmark debt management practices.

ENA is concerned that key analysis presented in the AER's draft working paper is not comparing apples with apples. Any analysis of the actual debt costs paid by networks should be compared to the actual return on debt delivered by the regulatory framework. This delivers a real return on debt plus actual outturn inflation. As figure 1 in our attached submission shows, the actual nominal cost of debt compensation delivered by the regulatory framework has been materially below actual nominal debt costs that networks have paid. This is not sustainable.

<u>Known material deficiencies in the EICSI index</u>

The attached submission sets out a number of fundamental deficiencies with the current construction of the Energy Infrastructure Credit Spread Index (EICSI) index, including for example, that the index:

- gives ten times as much weight to one-year debt as it gives to ten-year debt;
- assigns the same weight to a $1 million bank loan as to a $500 million bond issuance; and
- includes only a subset of the costs in relation to bank loans.

These critical issues were raised and discussed with the AER in the 2018 review but have not yet been addressed.

<u>EICSI index distorts incentives to the detriment of consumers</u>

The AER currently determines what it considers to be the benchmark efficient financing approach and sets the regulatory allowance accordingly. Networks are free to deviate from the benchmark efficient strategy if they choose, but any such

Energy Networks Australia www.energynetworks.com.au
Unit 5, Level 12, 385 Bourke Street Melbourne VIC 3000
P: +61 3 9103 0400 E: info@energynetworks.com.au

deviation has no impact on the regulatory allowance – consumers will only ever pay according to the AER's estimate of the benchmark efficient financing cost, and networks bear 100% of the risk that comes from any departure from the benchmark efficient strategy.

By contrast, under an approach of the EICSI being given weight in estimating debt costs, any deviation from the benchmark efficient financing approach *does* impact the regulatory allowance. This distorts incentives, which will either increase cost or risk (or both) ultimately borne by consumers. It will be impossible to continue to observe the underlying efficient practices of networks.

<u>EICSI index is complex and non-transparent</u>

Due to the confidential nature of the debt data, it is impossible for the construction of the EICSI index to be transparent to stakeholders. Consumers and networks can never know which debt instruments are included in the index nor the weight each instrument might receive. On top of these transparency issues, it is also unclear how the complex EICSI can be practically applied under a binding Rate of Return Instrument where there is no role for judgement during the annual debt cost update process.

<u>EICSI index is impossible to replicate</u>

Under the AER's current approach, a network can replicate the AER's allowance by issuing debt in accordance with the benchmark efficient financing strategy. That is, a network can issue 10% of its debt finance each year during the relevant averaging period to align its actual debt financing costs with the AER's allowance. A number of networks currently adopt that approach.

By contrast, a regulatory allowance based on the EICSI approach would be impossible to replicate because the index can only be computed in arrears.

That is, it is impossible for any network to issue its debt in a way that is consistent with the EICSI index. This raises the question of whether it is appropriate to set a benchmark efficient regulatory allowance on the basis of an approach that would be impossible for any network to implement.

ENA will work with the AER to refine the EISCI over time, which will enable the performance of the debt benchmarks to be monitored over time, and check that the AER's assessment of the benchmark efficient financing strategy remains appropriate. However, as outlined above, significant refinements are required to its construction.

Giving the EISCI weight in setting the debt allowance, even if its deficiencies were addressed, would have significant negative consequences for networks and customers. It is complex, opaque and would increase risk; it is impossible for any network to match the regulatory allowance made using the EICSI approach. It is hard to see how the distorted incentives it would create could be in the long-term interests of consumers.

Energy Networks Australia

<u>Different threshold for change</u>

The AER is currently running two consultation processes in relation to rate of return issues:

» In the regulatory inflation process, the AER has indicated that there is a very high threshold required before any change in approach could be contemplated. That point is made in a setting where:
  - the AER's current approach has consistently over-estimated inflation for over a decade;
  - the current approach is based on expected inflation of 2.5% in financial year 2023, which is implausible; and
  - The AER's own consultants have identified problems with the AER's current approach.

» In the return on debt process, the AER appears to be seriously contemplating a change in circumstances where:
  - the current approach remains fit for purpose and is working well;
  - networks are part way through transitioning to the approach that the AER adopted in its 2013 Guideline; and
  - the alternative approach has many already-known defects.

ENA is concerned about the potential inconsistency in the AER's approaches to these two issues.

If you wish to discuss any aspect of these issues, or have any additional queries, please feel free to contact [redacted] General Manager - Economic Regulation [redacted]

Yours sincerely,

[redacted]

Chief Executive Officer