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Dr Kris Funston
Executive General Manager, Network Regulation
Australian Energy Regulator
GPO Box 520
Melbourne VIC 3001

Dear Kris

2022 Rate of Return Instrument consultation process

The Chief Financial Officers ("CFO") of privately-owned Network Service Providers ("Networks") located in South Australia and Victoria welcome the opportunity to engage in the AER's 2022 Rate of Return Instrument consultation process.

Background

Aligning debt portfolio costs with the debt allowance is a critical and prudent feature of the Treasury Management Policies of our businesses. This is achieved through utilising a combination of entering interest rate swap hedges and issuing debt as close as reasonably practical to the relevant observation periods.

The capital structure of Networks is highly reliant on maintaining and accessing debt. Misalignment between the cost of debt and the AER's debt allowance increases cash-flow and refinancing risk which can lead to deteriorations in credit metrics resulting in a higher risk of credit downgrades, ultimately leading to a higher cost of debt for consumers.

The cost of debt component of the Regulated Rate of Return has been subject to robust and comprehensive reviews over the 2013 Rate of Review Guideline and 2018 Rate of Return Instrument ("RoRI"). Following the extensive review process, the majority of stakeholders (including Network, Consumer Reference Group, Investor Reference Group and Retailer Reference Group) accepted the transition to the proposed 10-year trailing average regime due to its merits of being transparent, replicable and representative of an efficient cost of debt allowance.

Transition

Following the 2018 RoRI guidelines, Networks commenced implementing their transition arrangements by aligning their interest rate swap hedging portfolios and debt portfolios (subject to practical and commercial constraints) to the AER 10-year trailing average approach. Consequently, Networks are at various different stages within their 10-year transitions depending on the timing of their respective Regulatory Reset periods.

Discussion

The CFO Group currently considers that the current 10 year trailing average debt benchmark represents a transparent and replicable debt management approach for Networks. The group believes this approach reduces the price variability risk to customers, as prices are set based on a benchmark, and not the underlying actual debt practice of the individual Networks.

The CFO group would be highly concerned if a less replicable and/or less transparent debt benchmark were adopted in the 2022 RORI. This would impede on the ability for Networks to align their regulatory cost of debt to the debt allowance and would increase cash flow and refinancing risks.

The matters currently being discussed in the AER's debt omnibus papers that particularly concern us are potential changes to the benchmark tenor and the use of the EICSI to inform a target average debt risk premium ("DRP") component of the debt allowance.

Debt Tenor

Changes to the tenor of the trailing average approach (from 10 years) could result in considerable amendments and repositioning of both debt and interest rate swap hedging portfolios to re-align to any new AER cost of debt methodology, provided it can be replicated.

For example, adopting a reduced tenor (e.g., an 8-year benchmark) as opposed to a 10-year benchmark would be inconsistent with Networks' current implemented debt management strategies of assuming that 10% of the debt portfolio is refinanced each year with new 10-year maturing debt over a 10-year period. Current treasury practices are positioned for this approach with all of them having adopted this approach and now at various stages in their 10-year trailing average transitionary arrangements. However, if the AER moved the benchmark term of debt to an 8-year tenor, the annual refinancing percentage would need to be adjusted to 12.5% of the debt portfolio over an 8-year period, to continue to provide the option for Networks to align their cost of debt to the debt allowance.

This change would have the cost implications associated with unwinding or transitioning the current interest rate swap hedging and debt portfolios to a new benchmark and potential reduced liquidity relative to a 10-year tenor. This change would also impact the Networks Cost of Equity, for example, requiring an increase in equity risk premiums to reflect the increased risk and volatility associated with financing long life assets (e.g., 20-to-50-year assets) with shorter duration debt portfolios.

EICSI

The level and pattern of the debt allowance, through time will be unhedgeable under this proposed approach. Such changes would have drastic implications for Network's debt management strategies and financing practices. It would also increase the level of risk to equity holders due to the less stable and predictable nature of cash flows.

Conclusion

Given the robust and comprehensive review of the regulatory cost of debt component in the 2018 RoRI, and majority acceptance of the position reached by key stakeholders, we consider there should be a very high bar for any change, particularly where such a change would disrupt Networks' execution of the current transitionary arrangements. Doing this attracts significant risk and costs for Networks to execute in a considered and replicable manner.

We urge the AER to seek to understand the practical implications of any change, particularly to a less transparent, independent and less replicable benchmark, and the long-term impact on changes in debt management strategies and practice, and the potential for higher prices costs to be passed back to customers.

We strongly endorse Energy Networks Australia's submission on this matter.

Yours sincerely

[redacted]

Mark Ellul
Chief Financial Officer

AusNet services

[redacted]

Garrick Rollason
Chief Financial Officer

CitiPower | Powercor Australia | united energy

[redacted]

John O'Dea
Chief Financial Officer

ElectraNet

[redacted]

David Gillespie
Chief Financial Officer

Jemena bringing energy to life

[redacted]

Kevin Jones
Chief Financial Officer

SA Power Networks