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Dear [redacted]

Response to Low Interest Rate Environment and Term of the Rate of Return Draft Working Papers

AusNet welcomes the opportunity to provide feedback on the Australian Energy Regulator's (AER's) Low Interest Rate Environment and the Term of the Rate of Return Draft Working Papers. We strongly support the Energy Networks Australia (ENA's) submissions to these papers. In this submission we offer some additional comments related to AusNet's circumstances.

Term of the Rate of Return – Debt

AusNet agrees with the AER that the terms of the expected inflation, debt and equity parameters do not need to align and can be separately determined.

In relation to debt, AusNet submits the efficient debt term should be set with regard to industry debt data. This should not be a mechanistic exercise where the AER looks solely at the average term at issuance across industry at a point in time and then applies the result as the benchmark debt term. Instead, the AER should exercise judgement and consider observed efficient financing practices over the long term. Transient factors, such as networks issuing shorter, or longer term, debt as a result of market conditions, or networks' debt practices varying after transactions, should not be considered as they are not relevant to benchmark efficient financing practices.

AusNet has consistently targeted longer-term bond issues with an average term at issuance of close to 10 years. This can be seen by the term to maturity charts below. Figure 1 shows that, as at 31 March 2021, we have debt maturing each year for the next 10 years.

Bond issuances of between 10 and 20 years tenor in the last financial year have led to AusNet's current weighted average debt maturity profile being extended to 7.6 years from 6.8 years[1]. This means AusNet's weighted average term to maturity at issuance (WATMI) greatly exceeds 10 years and has recently increased.

[1] AusNet Services, *Annual Report 2021*, https://www.ausnetservices.com.au/-/media/annual-report.ashx?la=en . Note for the purposes of this calculation the first call date is used for the subordinated debt issuances.

These charts also show that since 31 March 2018 (Figure 2) AusNet has also issued an increasing amount of very long term (i.e. 60 year) subordinated debt. Due to their subordinated nature, the interest payable on these instruments materially exceeds the benchmark debt allowance provided by the AER. We note that Dr Lally (2021)[2] recognises that a debt benchmark which does not include subordinated debt costs produces an allowance that is too low at the sector level. He also recognises that neither the Reserve Bank of Australia (RBA) nor Bloomberg indices include subordinated bonds. AusNet continues to consider that the AER should include subordinated debt in its Energy Infrastructure Credit Spread Index (EISCI) analysis to provide a complete picture of industry debt costs.

Figure 1: Debt Maturity Profile as at 31 March 2021

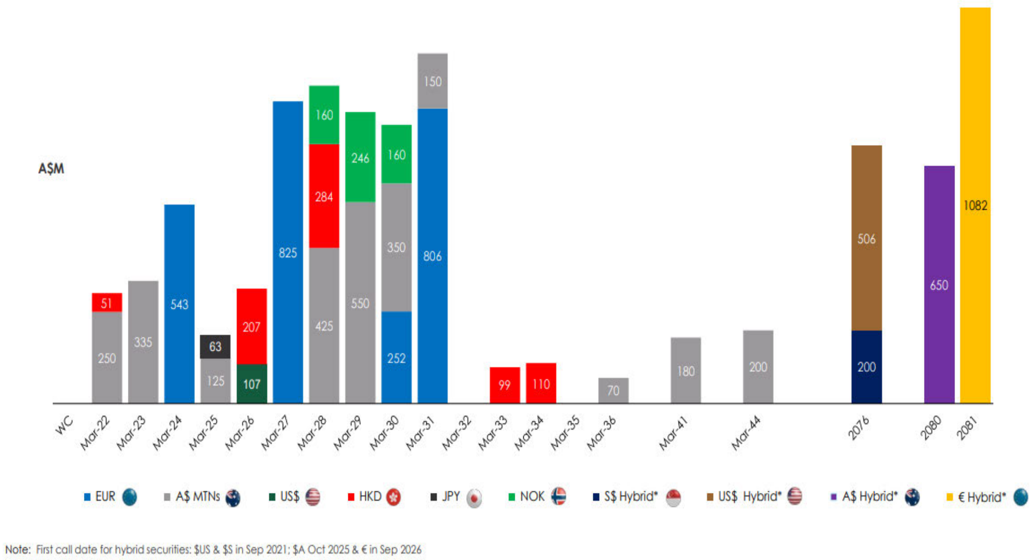
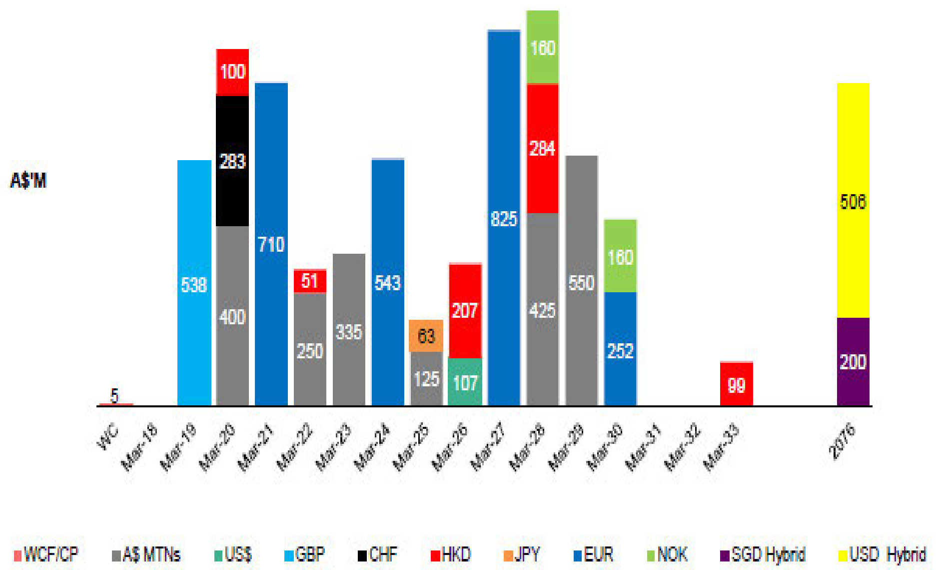


Figure 2: Debt Maturity Profile as at 31 March 2018



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[2] Dr Lally, *Appropriate term for the allowed cost of capital*, 9 April 2021

Given that industry data does not support a sustained change to the efficient debt term at issuance (and indeed AusNet's weighted average debt term at issuance is increasing), the evidence suggests that a 10 year term remains efficient.

In addition, AusNet is still transitioning to the 10 year trailing average approach across its three networks. Indeed, our gas distribution network will be transitioning until 2028 – after both the 2022 and 2026 RORIs are finalised. Any change to the term of debt in the 2022 RORI would necessitate an additional transition to reflect the change in the debt benchmark (as was applied when moving from the on-the-day to the trailing average approach). This would introduce unwarranted complexity and potential additional costs into the regime.

A change to the term of debt would also be a breach of regulatory certainty. In the 2013 Rate of Return Guideline Explanatory Statement, the AER concluded:

> *..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 debt 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. It also means that a 10-year transition will apply*[3]*.*

Re-opening this commitment in the 2022 RORI – as was also considered during the 2018 RORI process – is an erosion of regulatory predictability related to a critical part of running a regulated network whose core business is financing, building and maintaining long-lived infrastructure. This should be a critical consideration in the AER's decision making process about debt term. It is therefore concerning that the draft Working Paper does not acknowledge this commitment.

Trailing Average Approach to setting the Debt Benchmark

AusNet agrees with the AER's initial position to maintain the trailing average approach to the return on debt, with annual updating. This approach was adopted in the 2013 Rate of Return Guideline following a rule change proposal submitted by the Energy Users Rule Change Committee[4] after the Global Financial Crisis.

The AER's implementation of this customer-led approach ensures that customers pay smoother prices, aligns to efficient debt costs, and are not unduly exposed to market shocks. It is also a benchmark approach that networks can – and do – replicate, to manage refinancing risk. This assists networks to attract high quality investment and keep prices low.

Financeability and Cash Flows

AusNet supports the introduction of a financeability check both at the time of the RORI and in individual determinations. This is a prudent practice adopted by many international and Australian regulators. Internally inconsistent decisions (whereby inadequate cashflows are provided to support the assumed benchmark credit rating) could lead to industry-wide credit

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[3] AER, *Better Regulation - Explanatory Statement – Rate of return guideline,* p.137

[4] Energy Users Rules Change Committee, *Proposal to change the National Electricity Rules in respect of the calculation of the Return on Debt,* 17 October 2011 https://www.aemc.gov.au/sites/default/files/content/e1fcfa7b-23e8-43c7-92fb-eb825025620f/Energy-Users-Rule-Change-Committee-Proposal.pdf

rating downgrades over time which, in turn, would reduce the benchmark credit rating used to set the cost of debt and increase prices for customers. Therefore, financeability checks are prudent cross-checks for the AER to undertake.

Since the 2018 RORI the combination of the decline of the 2018 RORI equity parameters, the government bond rate and the AER's previous approach to setting expected inflation which was far less responsive to market conditions, has led to the following outcomes in AusNet's Electricity Distribution Network Draft Decision:

- Material negative NPAT of -$135m over the 5 year period; and
- FFO/Debt averaging 7.8% for each year of the regulatory period. For reference, this is consistent with and Standard and Poor's rating of BB; well below BBB+.[5]

Based on AusNet's experience in how credit rating agencies undertake their assessments, these outcomes are not consistent with the benchmark entity maintaining a BBB+/Baa1 credit rating.

We acknowledge that recent recoveries in the government bond rate and the change in the AER's methodology to setting expected inflation have both contributed to the easing of cash flow pressures in the Victorian Final Determinations (this is a separate issue to whether the allowed cost of equity was appropriate – as outlined in the ENA's submission the allowed cost of equity remained materially below those granted by comparable international regulators, despite the slight recovery in government bond yields between the Draft and Final Decisions). However, AusNet's transmission Draft Determination published on 30 June 2021 contained an FFO/debt of 8.8% average over the regulatory period, which is consistent with a BBB credit rating.

While a range of factors should be considered in financeability testing, not just FFO/debt, these circumstances indicate that there is merit in financeability testing being introduced as a safeguard. Its use would help avoid undue and potentially unforeseen consequences that may arise from a range of potential factors during the period in which the binding 2022 RORI applies, including changed market conditions.

Please contact me on [redacted] with any questions in relation to this submission.

Sincerely,

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Manager Economic Regulation
AusNet Services

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[5] Frontier Economics, *The Impact of Artificially Supressed Government Bond Yields,* 23 Nov 2020. https://www.aer.gov.au/system/files/AusNet%20Services%20-%20Revised%20Regulatory%20Proposal%20-%202021-26%20-%20Frontier%20Economics%20-%20Appendix%207A%20Frontier%20supporting%20report%20-%20December%202020.pdf