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Mr Warwick Anderson
General Manager, Network Finance and Reporting
Australian Energy Regulator
GPO Box 3131
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Dear Warwick,

Response to the AER's Discussion Paper on Estimating the Allowed Return on Debt

The regime for setting the regulatory debt allowance has been relatively stable over time. Where there have been changes historically, these have served to promote stability, which is valued by investors and customers. The stability enables quality investment to be attracted into the sector, ultimately benefiting customers through lower prices. Over the previous 10 to 20 years, there has been a great deal of stability in key debt parameters, including the benchmark credit rating (BBB+), the use of third party yield curves to set the benchmark allowance, and the benchmark term of debt (being 10 years).

It is appropriate that the approach to setting the regulatory debt allowance is reviewed periodically to ensure it continues to reflect efficient financing costs. This is consistent with the premise of incentive-based regulation – a benchmark is fixed for a period of time, during which businesses have an incentive to outperform this benchmark. During the review, if there is evidence to support a systematic adjustment to benchmark efficient financing costs, this should result in an adjustment to the benchmark. This ensures that customers continue to benefit from incentive-based regulation as businesses recover no more and no less than their benchmark-efficient financing costs.

This submission focuses on three key issues outlined in the Discussion Paper:

- Benchmark term of debt of 7.5 years;
- Implementation of the benchmark credit rating; and
- Selection of third party data series.

Benchmark Term of Debt

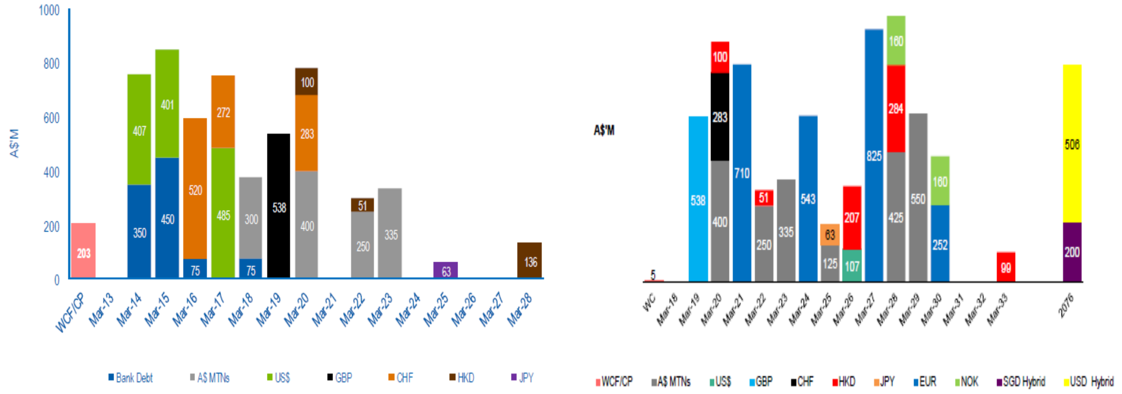
The AER has collated data on actual debt portfolios from privately owned and listed businesses. In analysing this data, it has concluded that between January 2013 and December 2017 the weighted average term at issuance was equal to 7.4 years, and the simple average term at issuance was equal to 7.5 years.

During the 2013 Rate of Return Guideline review the AER determined that issuing staggered debt with a 10 year term was representative of efficient benchmark debt financing practices. AusNet Services was one of the firms from which the AER collected debt portfolio data to inform its assessment of benchmark efficient practices.

During the 2013 review, the change to a trailing average debt approach was broadly supported by stakeholders as it had the advantage of providing even greater certainty and stability in both the debt allowance and prices. The industry is currently transitioning to this new approach, to ensure that the benefits can ultimately be realised.

AusNet Services can confirm that as it is transitioning to a trailing average cost of debt it continues to have a staggered long term debt portfolio, with debt reaching maturity every year for the next 12 years. The average remaining term of debt has increased since the 2013 Guideline review. This can be seen from the debt maturity profiles below, which show the debt maturity profiles as at 31 March 2013 (LHS) and 31 March 2018 (RHS).

Figures 1 and 2: Debt Maturity Profile as at 31 March 2013 and 31 March 2018



AusNet Services understands debt portfolios of other long established listed and unlisted private entities also reflect this lengthening of maturity post 2013. This would be expected as the change in the benchmark approach means it is even more desirable for businesses to issue longer term debt as replicating the regulatory benchmark reduces the risk of a mismatch between the regulatory debt allowance and debt costs.

It is therefore unexpected that the AER's analysis points to a reduction in the benchmark term to 7.5 years.

AusNet Services understands that the majority of the reduction in the average term is driven by the inclusion of recently-privatised network debt issuance in the sample. As would be expected, acquisitions of recently privatised networks were initially funded by vast amounts of short term debt. Again, as expected these businesses can be expected to, and evidence suggests they are, to gradually build a staggered debt portfolio to match the benchmark approach. They could not fund the initial purchase through the issue 10 year debt because the refinancing risk of these entities would be intolerable, as their entire debt portfolios would expire in approximately 10 years' time.

It is clear that the recent bout of privatisations is irrelevant when setting an efficient benchmark term of debt. The benchmark should reflect stable financing practices and temporary changes due to specific matters impacting a handful of businesses should not result in a change to the benchmark. This would lead to uncertainty for investors, and would also result in a change to the financing practices of businesses, to shorten terms at issuance to align with the new benchmark term. As this change would be driven purely by the benchmark, it cannot be said to reflect efficient financing practices as would exist in the absence of regulation. This is unlike the current 10 year benchmark term, which was set by observing the financing practices of benchmark efficient term, under a different regulatory approach which was somewhat divorced from the actual term of debt issues.

The materiality of the impact of privatisations should be presented by the AER. As stakeholders are unable to see data on the average term at issuance for all businesses, they will be unable to make an informed comment on whether the benchmark term should be changed as a result of this analysis.

The other driver that needs to be untangled is the inclusion of bank debt in the AER's sample. Some networks (including AusNet Services) utilise bank debt as essentially as an offset facility to better manage the timing differences between debt maturing and debt issuance. It is not used to directly fund the asset base. These sorts of debt facilities remain undrawn for long periods of time and are not relevant to assessing the benchmark term.

Implementing the Benchmark Credit Rating

AusNet Services considers the industry evidence continues to support a benchmark credit rating of BBB+.

The issue is how the AER should best implement a BBB+ benchmark in setting the cost of debt. We agree with the ENA's concerns about the methodological and sampling choices made in the Chairmont analysis that appears to establish systematic outperformance of the benchmark set with reference to broad BBB curves. This needs to be improved to ensure stakeholders can be confident in its conclusions. However, if persistent outperformance is well-established, then an option is for the AER to place weight on the A curve to ensure that customers benefit from any established systematic reductions in efficient financing costs.

Selection of Third Party Data Series

AusNet Services considers the current third party data series approach is working well and the marginal benefits in adding two additional curves, being Reuters and Standard and Poor's (S&P) would not justify the additional administrative costs.

In addition, AusNet Services has significant concerns in relation to the S&P curve, given it is a clear outlier when compared with the other curves, and the reason for this is not at all clear. While there is also a lack of transparency over other third party data series such as Bloomberg, which is used by the AER, this is more of a concern in relation to S&P given that unlike Bloomberg, the bonds in its sample are not publically available and, unlike Bloomberg, it is a systematic outlier compared to the other three curves. There would need to be a great degree of confidence that the S&P curve is more reflective of the financing costs of an efficient entity before it is incorporated, given the materiality of its inclusion.

Please contact Charlotte Eddy, Manager Economic Regulation on 03 9695 6309 with any questions in relation to this submission.

Sincerely,

Tom Hallam
General Manager, Regulation and Network Strategy
AusNet Services