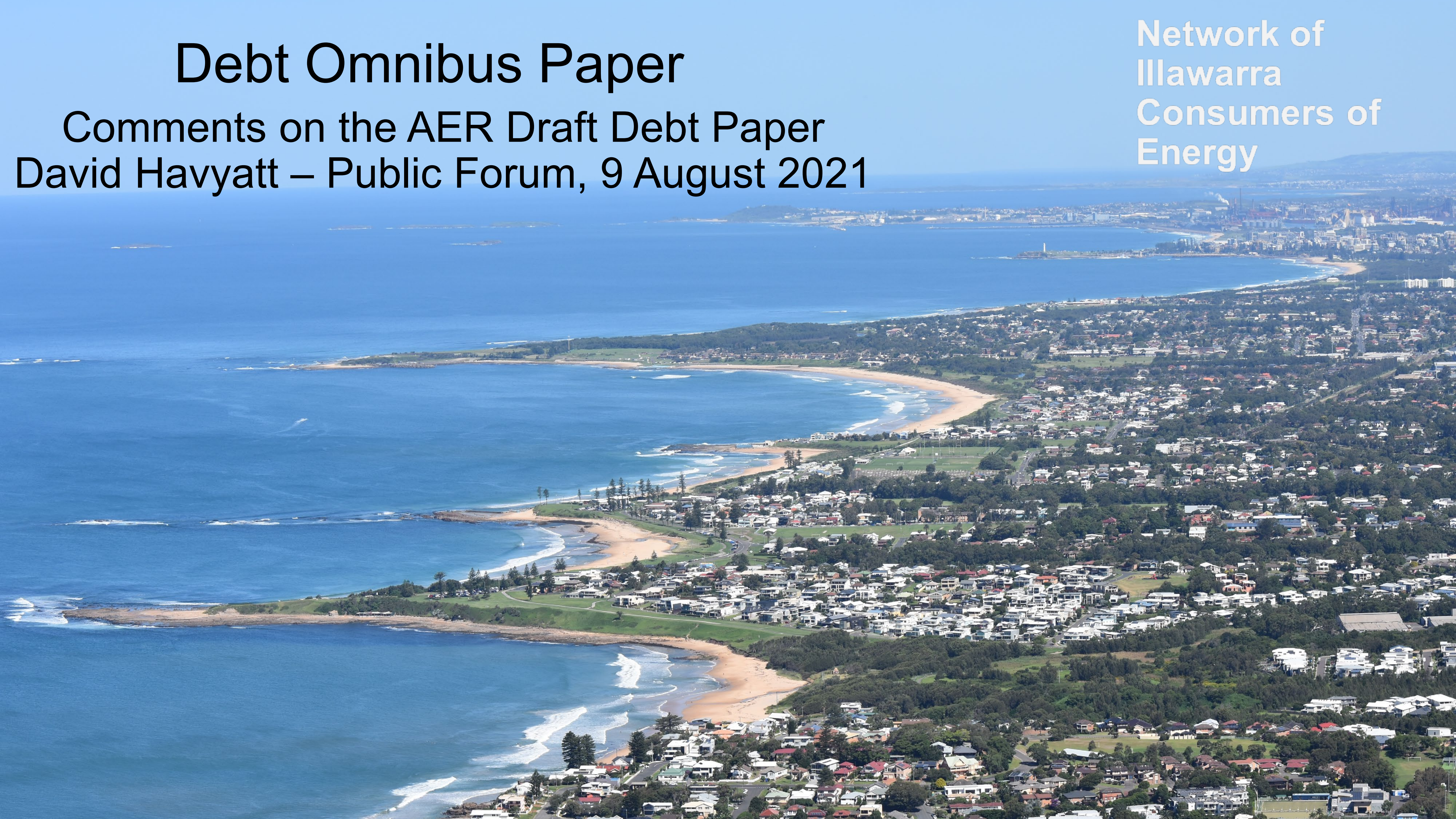
Debt Omnibus Paper

Comments on the AER Draft Debt Paper

David Havyatt – Public Forum, 9 August 2021

Network of Illawarra Consumers of Energy



Background

- The AER is estimating the lowest rate of return required by a network business to fulfill its financing requirements:
  - Uses the same rate of return for all businesses
  - Estimates using a WACC + CAPM approach
  - Chooses a final value from a range exercising judgement on how the ARoR best achieves the NEO/NGO

- The AER does not generally estimate a separate debt cost for each business
  - Only exception is the firm's choice of averaging period timing

- The AER's rationale for the use of the ten-year trailing average is:

  The benefits of the trailing average approach is that is provides NSPs with a regulatory benchmark that they can more readily match each regulatory control period. As such, this provides a benchmark efficient entity with an enhanced opportunity to minimize any mismatch between actual costs and regulated revenues.

A simple observation

- The ways that entities manage their capital requirements are far more complex than the simplistic WACC + CAPM approach can capture…

  therefore in setting the ARoR the AER is necessarily in the business of making simplifying assumptions, and…

  if these simplifications can be clear and time consistent, then…

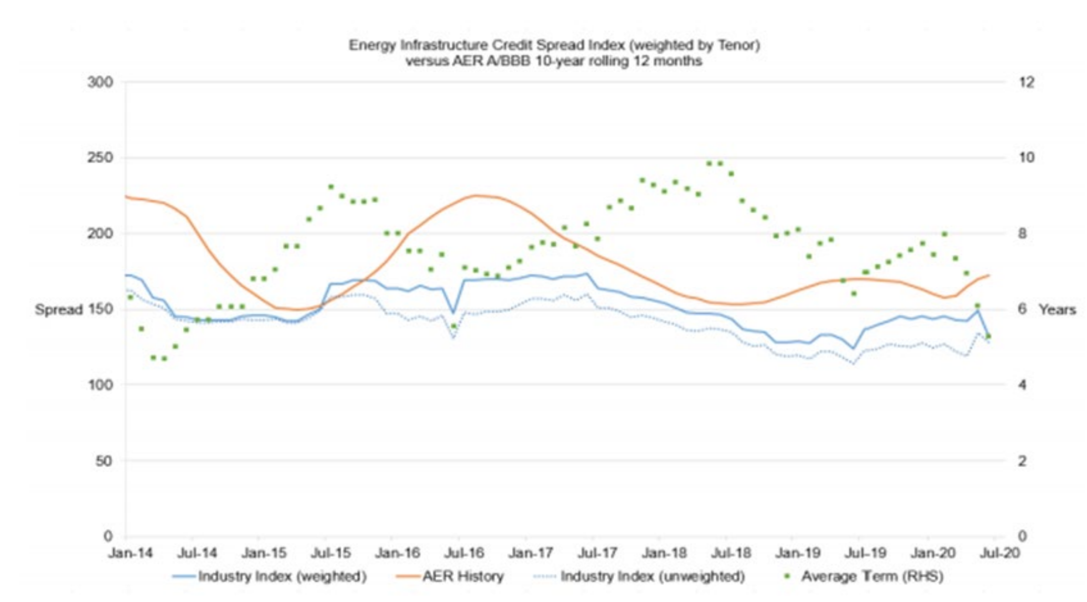
  network businesses can efficiently manage their capital management against known standards.

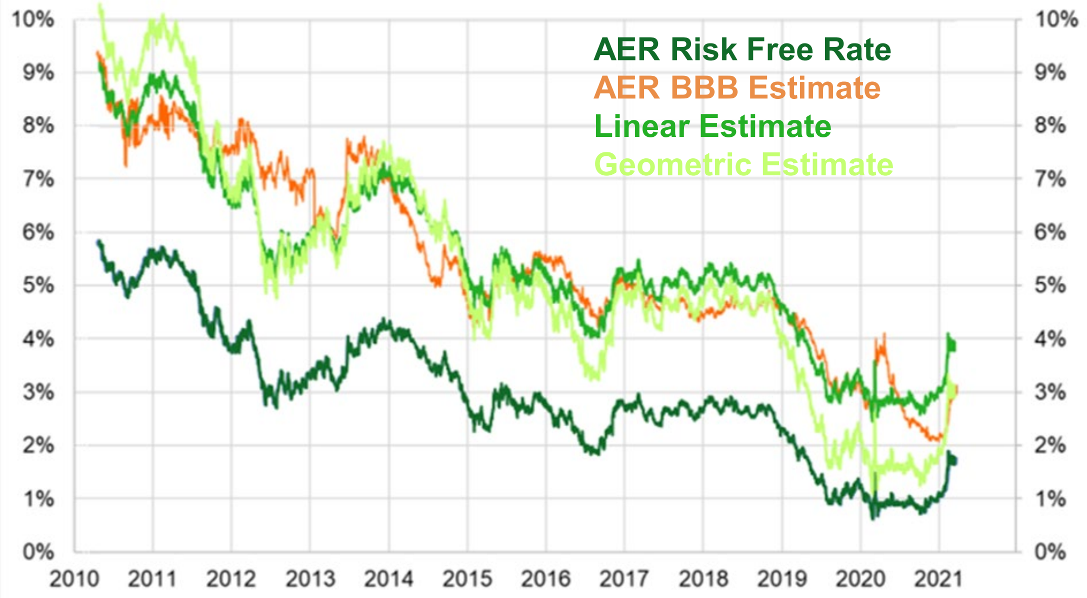
NICE responses to AER Topics

AER Issue	NICE Response
The use of the EICSI	The EICSI should be used directly and the Cost of Debt set as RFF plus identified spread
Capex weighting in trailing average	It should be unchanged
Averaging Period Timing	Unless the proposal on EICSI is adopted, support AER
Debt Data Providers	Unless our proposal on EICSI is adopted, support AER (no change)
Instrument selection for use in the EICSI	We support the AER in continuing to use the existing instruments, though we suggest a separate index be constructed using the other instruments as well
Benchmark Credit Rating	We believe the BBB+ credit rating remains appropriate on a 'first principles' basis – this is based on the explicit financial capital maintenance principles of the framework
Instrument Contingencies	Unless the proposal on EISCI is adopted, support continuation of previous principles
Debt Raising Costs	These are not part of rate of return, they are Opex. We support the AER gathering data to better assess debt raising costs.

Use of EICSI

- The EICSI (see AER Fig 1) has been used by AER to estimate weighting between A and BBB to get BBB+
- It shows that networks use variation in term to achieve a relatively stable spread over the 3-month bank bill swap rate
- Over six years this spread has varied by very little from 150 basis points above the bank bill swap rate
- The second chart is figure 9 from the AER's Cashflow working paper with two fitted curves from estimates
- Apart from some small deviations the linear estimate is a good estimate – but it is still mostly proportional
  *y=0.016710937 + 1.287559981 * r*
- *Note the relationship between RFR and BBB is not a simple spread – spread declines as RFR declines*
- The use of ten year trailing averages will average out variability






Rfr
Linear
Additive Spread
10%
9%
8%
7%
6%
5%
4%
3%
2%
1%
0%
2010
2011
2012
2013
2014
2015
2016
2017
2018
2019
2020
2021
AER BBB estimate
AER risk-free rate

Capex Weighting

- AER argument – this will address capex lumpiness
- Counter arguments:
  - In different circumstances it risks locking in very high rates over the ten years when a network would take the high rate for a short term and then roll-over at lower rate
  - It doesn't address the ongoing potential lumpiness of future debt raising as the initial raising is rolled over (though one would expect the network to raise different amounts of the debt with differing tenors)
  - If it is reasonable to start developing case specific weighting then it would be equally appropriate to otherwise solve the issue by reducing benchmark gearing
  - Not yet clear that the TNSPs are going to raise equity capital – i.e. they may really be planning to raise capital through increased gearing if they can do so
- How to solve the problem
  - If TNSPs cannot finance ISP projects and maintain BBB+ credit rating it reflects a failure of the policy of privatisation – nothing more and nothing less
  - When the private sector cannot finance essential infrastructure government must intervene
  - Government can intervene by providing sub-ordinate debt at AAA rating
  - The LTIC in the AEMA binds governments, not just market bodies