SP AusNet™
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Mr Warwick Anderson
General Manager – Network Regulation Branch
Australian Energy Regulator
GPO Box 3131
Canberra ACT 2601

rateofreturn@aer.gov.au

Dear Warwick,

Re: Rate of Return Guideline Consultation Paper

SP AusNet welcomes the opportunity to provide comment on the AER's Consultation Paper. This response provides the company's perspective on cost of debt matters. With respect to the broader rate of return, the company endorses the positions outlined in the Energy Network Association's (ENA) submission and does not propose to repeat the detailed responses in its own submission.

Cost of Debt Benchmark

As noted in SP AusNet's submission to the Issues Paper, SP AusNet currently manages its debt portfolio through staggered debt issuances with a swap overlay matching the regulatory period (referred to as the 'hybrid approach'). Within the context of the current regulatory approach to setting the cost of debt, SP AusNet has found this to be an efficient financing practice to date.

SP AusNet recognises the AER's preference for a single benchmark approach for estimating the return on debt. If that were to be a trailing average portfolio approach[1], then annually updating allowed revenue to incorporate changes in the cost of debt would be essential for SP AusNet to manage its financing arrangements under this benchmark in the most efficient and prudent manner, particularly during transition. Any transitional arrangements put in place must be sound and provide appropriate compensation for businesses transitioning to the new benchmark while also considering customers.

Annual Updating

The AEMC has explicitly allowed for an annual adjustment to the return on debt in the Rules. Providing a close match between the actual cost of debt incurred and the

[1] For example, the approach outlined in the ACCC's Regulatory Development Branch (RDB) paper 'Estimating the Cost of Debt'

regulatory allowance for the cost of debt is in the interests of both businesses and customers. As SFG Consulting sets out in a report to the AEMC[2], when it comes to matching the actual cost of servicing debt and the regulatory allowance, shareholders and customers are on opposite sides of the same risk:

> *'If there is a mis-match between the cost of servicing debt and the regulatory allowed return, then in some cases shareholders receive excess returns and customers pay relatively too much. But the reverse also occurs just as frequently. This means that shareholders and customers both wear the same risk – they are simply on opposite sides of it. If the allowed return can be made to match the cost of serving debt, the risk is eliminated for both shareholders and customers.'*

This is true both across, and within, regulatory periods. Without annual updating, cashflow volatility resulting from a mismatch between actual debt service payments and the regulatory return on debt will flow through to equity holders, who will require a higher rate of return from taking on additional risk. Currently this volatility is somewhat smoothed by hedging the swap rate to the regulatory allowance for this parameter (although there remains volatility in the DRP).

Evidence on the materiality of the expected mismatch between actual debt service payments and the regulatory return on debt in the absence of annual updating has been put forward by the Queensland Treasury Corporation (QTC)[3]. This demonstrated that, under particular assumptions, the average standard deviation over a regulatory control period of the mismatch in a regulatory year is equal to 38 basis points. It is noted that the likely mismatch increases over a regulatory period, such that in year 5 the average standard deviation equals 61 basis points. A mismatch of 38 basis points corresponds to about 1.1 per cent of allowed revenue, and a mismatch of 61 basis points to about 1.8 per cent of allowed revenue. The mismatch exceeds the 1% cost pass through threshold under the NER.

The average mismatch is likely to be higher during a period of transition between benchmarks. This is because estimating the cost of debt at the beginning of a transitional period, on a forward looking basis, is more likely to be erroneous than estimating the cost of debt once a trailing average approach has been embedded. This is especially true if forward-looking swap rates are used during the transition. Therefore, the starting point of the transition is likely to contain an initial error, which, in the absence of annual updating, could be compounded as the regulatory period proceeds.

QTC's historic analysis using US interest rates demonstrates that the direction of the mismatch tends to persist across periods. This can lead to networks being undercompensated and customers paying lower than efficient costs, or, as is just as likely, vice versa, for substantial periods of time (in this analysis, several decades). This is not in the interests of either customers or businesses – as discussed above, these parties are opposite sides of the same risk.

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[2] SFG, *Rule change proposals relating to the debt component of the regulated rate of return*, 21 August 2012

[3] QTC, *Mismatch Modelling Summary – Preliminary Results for Discussion,* circulated 13 June 2013

The AER's consultation paper has expressed views that annual updating would increase the complexity of the annual tariff computation. However, under a trailing average approach the cost of debt would have to be estimated for each year of the period in any case. Feeding this annual estimate into the annual tariff computation would not be a complex exercise given that allowed revenue is updated annually for various factors including pass throughs and STPIS payments anyhow. There is also a significant material benefit that arises from this update which should be fully considered against the (minor) administrative burden the AER would face from implementing annual updating.

Concerns about data sources such as Bloomberg becoming unavailable mid-period need not prohibit annual updating. NER 6.5.2(l) requires that annual updating is an automatic process as specified in the relevant regulatory determination. It is possible to specify the annual cost of debt estimation in a way that provides for data becoming unavailable mid-period. For example, the determination could set out that were a Bloomberg Fair Value curve to become unavailable mid-period, an approach to curve fitting (both the model for estimation and the data sample to be used) would be specified. The determination could also specify that as a last resort, in the absence of any suitable data, the current cost of debt would continue to apply for the remainder of the period.

A possible alternative to annually updating the cost of debt is to true-up the mismatch at the end of the regulatory period, such that the difference is included in allowed revenues for the following regulatory period. However, this is not suitable as it does not reduce the volatility of cashflows resulting from the mismatch year on year. As explained above, this volatility is important to both businesses and customers. In addition, a true-up mechanism would result in significantly greater price volatility between periods than annual updating, as demonstrated by CEG's memo 'Impact of annual updating on revenue smoothing'[4] which has been provided to the AER and other stakeholders. This is because, in periods of increasing interest rates, the true-up at the end of the period would increase the regulatory allowance for the following period. The cost of debt allowance would also increase, as the increasing interest rates would be factored into the trailing average set for the next period. The positive true-up would be additional to this increase, whereas with annual updating, only the increase in the cost of debt allowance would be factored in. It is price volatility from period to period that has driven customer concerns with the current approach, so this needs to be a critical consideration for any new approach.

In addition, annually updating the cost of debt is essential during the period of transition to a trailing average approach, as there is a need to incorporate staggered debt issuances during the regulatory period into the cost of debt allowance. After the transition period(s), annually updating the cost of debt is likely to have become a well-established process with minor costs that are outweighed by the benefits to both network service providers and customers of closely matching the allowed cost of debt to the actual cost of debt.

The RDB's paper suggested that annual updating is not required as there is a natural hedge over time. Attachment 1 – 'Critique of RDB's natural hedge and annual updating' sets out why this natural hedge is problematic to the extent that it is inconsequential.

[4] CEG, *Impact of annual updating on revenue smoothing,* 17 June 2013

Transition

The following criteria should apply to determining an appropriate transition path:

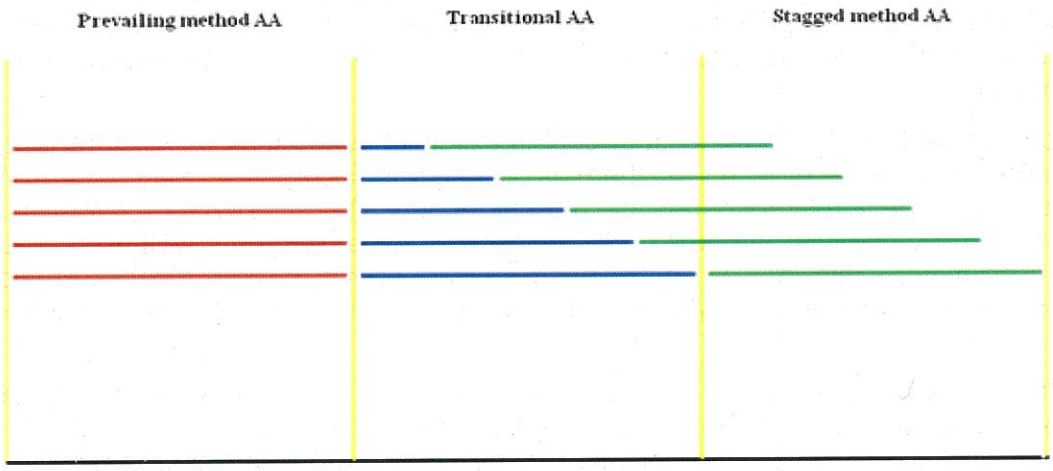
- Should compensate businesses consistent with NER 6.5.2(c). Note that this refers to 'efficient financing costs of a benchmark efficient entity'.
- Should avoid large step changes in prices as this could create problems for customers to manage.
- Should maximise certainty for consumers and businesses (consumers interested in certainty over prices so they can plan for changes, and businesses interested in certainty of cashflows).

While the policy rationale for having a benchmark to benchmark transition is sound, the problem with this approach is that the current benchmark is not hedgeable. However, SP AusNet also recognises the AER's concerns around transitioning from existing business practice leading to a multitude of transition paths. Therefore a pragmatic approach, recognising both the current benchmark and efficient financing principles, is required to satisfy the criteria above. The transition path outlined by QTC is an example of such a pragmatic approach.

The transition paths proposed by the ACCC's RDB and QTC are discussed below.

1) RDB paper

The RDB outlined a potential transition path that would result in a staggered portfolio of debt, consistent with implementing a trailing average benchmark. The diagram below illustrates this transition path for a 5 year trailing average (but, as RDB's paper notes, this approach could also be applied where the trailing average is over 10 years).



Source: RDB paper

The debt allowance set for the transitional period is determined as 20% each from 1 year to 5 year fixed rate debt i.e. compensates for the blue lines of debt issued in the above diagram. This transition path is unacceptable as it does not compensate businesses for the staggered 5 year fixed rate debt issued throughout the period (i.e. the green lines that fall within the transitional period). It effectively assumes that the business completely unwinds its entire debt portfolio over the transitional period – no business would do this.

Modifications to this approach have been suggested, including using forward-looking spot rates to compensate for the fixed rate 5 year debt issued throughout the period, represented by the green lines. However, forward-looking spot rates are subject to large fluctuations over time, which means the mismatch between the regulatory allowance and the actual cost of debt is likely to be high if this approach were implemented, at a risk to both businesses and customers. To resolve this, annual updating could be used to factor into the regulatory allowance the actual cost of 5 year debt at the actual time of issuance.

This modified RDB approach continues to assume that it is efficient for businesses to issue short-term debt. Due to high refinancing risks associated with issuing short-term debt (which has been discussed in previous WACC reviews and during the AEMC's Economic Regulation of Network Service Providers Rule Change), it is not efficient for network businesses to do so. This approach could be improved by recognising that the benchmark efficient term of debt is, and should remain, at 10 years. Therefore, the term of debt compensated for should not be below 10 years at any point.

2) QTC approach

Setting a cost of debt allowance for the transitional period based on the estimated cost of debt with a term of 10 years, and assuming that 10% of a businesses' debt portfolio is refinanced each year with 10 year fixed debt at prevailing rates until the debt portfolio is evenly staggered is an equitable approach to transitioning from the current to a new, trailing average, benchmark. Annual updating is required to account for the staggering. This approach will not result in windfall gains or losses for either network businesses or customers, and uses forward looking data only.

Definition of the Benchmark Entity

During the 18 June workshop on the relationship between risk and the rate of return, it was flagged that AER staff consider that the benchmark entity should be defined as an entity with parent ownership. The full implications of this for determining the cost of debt and equity are unclear, however, AER staff indicated that this could impact:

- Cost of debt – parent ownership could reduce the cost of debt due to the potential for parental support in the case of default.
- Cost of equity – transaction costs of issuances may be spread over a larger entity.

There are sound economic arguments for not including parent ownership in the definition of a benchmark firm. The ownership of an entity does not change the total risk associated with the regulated assets; although in some cases some risk may be transferred to the parent. As the ENA's submission to the AER's Issues Paper states:

> *'The policy weakness of adopting a benchmark firm that is part of a corporate group structure is that such structures can often involve the parent assuming risks for the subsidiaries or subsidiaries assuming risks for each other. To include the group ownership structures in the benchmark efficient entity would obscure those risks and has the potential to under or overcompensate the actual network service provider.'*[5]

In addition, the allowed rate of return objective (NER 6.5.2(c)) is:

> *'the rate of return for a Distribution Network Service Provider is to be commensurate with the efficient financing costs of a benchmark efficient entity with a similar degree of risk as that which applies to the Distribution Network Service Provider in respect of the provision of standard control services (the allowed rate of return objective).'*

This clearly specifies that the benchmark efficient entity must be one with a similar degree of risk in respect of the provision of standard control services. For this reason, the benchmark entity must be a stand-alone, pure play entity. Considering the implications of parent ownership for the benchmark firm is not consistent with the rate of return objective.

In addition, the industry has seen 'halo' effects due to parental ownership removed from credit ratings recently. Very few private firms currently receive a credit rating uplift due to parental ownership. SP AusNet's credit rating, for example, has recently been lowered by Standard and Poor's from A- to BBB+ following the sell down of 19.9% by Singapore Power International to State Grid International Development Ltd. Standard and Poor's assessment of this downgrade stated that 'we no longer consider that the ratings on SP AusNet ... benefit from any rating uplift due to parent support'[6]. Following this transfer, SP AusNet no longer has a majority shareholder and so it is unclear whether the AER would consider SP AusNet to have parental ownership.

Effectively setting regulatory allowances with regard to ownership is also problematic as it could incentivise particular industry and corporate structures which may not be efficient. This could also penalise businesses without, or that do not receive a benefit from, parental ownership, despite it not being clear that parental ownership in itself is desirable. In addition, ownership structures are mostly outside the control of regulated businesses'.

If parental ownership is determined to be a characteristic of the benchmark firm, then the impact on the value of imputation credits will need to be considered. Given that parent owners of Australian regulated businesses are generally domiciled outside of Australia, the ability of shareholders to use imputation credits is significantly reduced.

Conclusion

In summary, SP AusNet can support the implementation of a trailing average approach for setting the regulatory allowance for the cost of debt provided that annual updating is

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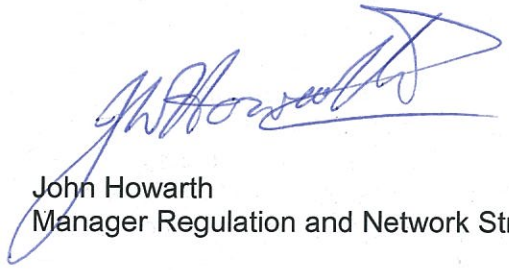
[5] ENA, *Response to the AER Rate of Return Guidelines – Issues Paper*, February 2013

[6] Standard & Poor's, *Ratings On SP AusNet And SPI Australia Lowered To 'BBB+' And 'BBB' On Singapore Power Sell-Down*, 17 May 2013

implemented to minimise volatility for both businesses and customers. In addition, any transition should recognise efficient costs to be incurred by a business in transitioning to the new approach, while also smoothing the impact on customers. SP AusNet considers that the transitional arrangements proposed by QTC (or perhaps a close variation of these) achieve these objectives.

I hope you find this document useful and should you have any questions in relation to these matters please contact Charlotte Coster on 03 9695-6309.

Yours sincerely,



John Howarth
Manager Regulation and Network Strategy

Attachment 1 – Critique of RDB's natural hedge and annual updating

The Regulatory Development Branch's paper 'Estimating the Cost of Debt – A Possible Way Forward' (April 2013) sets out a possible portfolio approach to estimating the cost of debt for regulated businesses. This attachment responds to this paper on two points, the supposed 'natural hedge' arising from the portfolio approach, and the consideration of annual updating.

Natural hedge

The RDB offers a mathematical proof of the natural hedge over time arising from setting a benchmark based on a trailing average cost of debt, without allowing for annually updating over the period. While mathematically this appears sound, in reality the 'hedge' falls short in a number of ways, including:

- Where the benchmark term of debt is equal to ten years, the natural hedge will take up to 15 years to fully wash through. This is unacceptably long, even if the regulatory allowance were adjusted to account for the time value of money
- Despite the percentage of misspecified inputs falling as the benchmark term of debt increases, the benefits of this are signficantly outweighed by the much longer time that it would take for the natural hedge to work.

In addition, the strict assumptions quoted by the RDB that allow this natural hedge to work mathematically do not hold in the real world. For example:

- The natural hedge only works where the benchmark term to maturity is a whole number multiple of years of the access arrangement. However, SP AusNet's transmission business currently has a 6 year regulatory period, and its next regulatory period will last 3 years. No decision has been made on the length of future reguatory periods, but it is not a given that it will be 5 years.
- The regulated businesses capital base is clearly not constant over time.

Annual updating

The arguments presented in opposition to annual updating are addressed below:

- Shifts interest rate risk from NSPs to customers – the change in the interest rate will impact prices every 5 years anyhow, so customers are already exposed to this risk. Annually updating the cost of debt will smooth the price path that results from changes in the interest rate, which is in the interest of customers. If the cost of debt is not updated annually, then businesses will experience a high level of cashflow risk.
- Incentive for opportunistic reviews – intra-period adjustments to the cost of debt must be applied automatically under the NER. This limits the scope for applying regulatory discretion, and therefore the likelihood of appeals.
- Increases tariff volatility within period – although this is true, it also reduces tariff volatility between periods. A smoother price path is in the interest of customers. This consideration drove the Rule Change that led to this process.
- Increases complexity and adminsitrative costs – under a trailing average approach, an estimate of the cost of debt for every regulatory year would have to be made anyhow. Updating allowed revenue annually to reflect this would only require limited additional resources, as allowed revenues are generally annually

updated anyhow to reflect various pass throughs, STPIS payments e.t.c. The benefits of annual updating would be likely to exceed these relatively minor costs

- Increased uncertainty for NSPs – while annual updating would increase uncertainty over allowed revenues, it would increase certainty over cashflows, which is of greater importance to NSPs.