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Mr Warwick Anderson
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Dear Warwick,

RE: WACC Guideline Issues Paper

SP AusNet welcomes the opportunity to provide comment on the AER Issues Paper. The company endorses the positions outlined in the ENA submission and does not propose to repeat the detailed responses in its own submission.

Problems with the existing method

During the AEMC review, customer groups highlighted a number of weaknesses and limitations of the current 'on the day' approach to estimating the benchmark cost of debt. In particular, this approach can result in volatile movements in the cost of debt from one regulatory period to the next which increases price volatility.

SP AusNet considers that, for all but the smallest of network service providers (NSPs), the efficient debt management strategy that is implied by the current 'on the day' approach cannot be implemented by the benchmark efficient NSP. This is because sourcing all of an NSP's debt in a small sample period every regulatory period places an unacceptable refinancing risk on the business. Furthermore, for the largest networks, Australian debt markets are simply not liquid enough to absorb such a large issuance over such a limited amount of time from one company. This problem is compounded when multiple determinations fall within a short space of time.

As the efficient benchmark business is typically unable to manage debt using the strategy implied by the current 'on the day' approach, this results in a differential between the allowance for the return on debt and the actual debt service costs incurred by an efficient benchmark entity. This results in an inefficient outcome because:

- Where the actual benchmark efficient cost of debt falls below the allowed cost of debt calculated using the 'on the day' approach, consumers face higher prices than are necessary for an efficient outcome; and

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- When actual benchmark efficient cost of debt exceeds the allowed cost of debt calculated using the ‘on the day’ approach NSP investment decisions are distorted. Efficient discretionary investments are discouraged. In addition uncompensated risks can arise in relation to investments that are mandated by regulatory standards.

Therefore the current approach to estimating the efficient cost of debt adversely affects customers due to increasing price volatility and distorting investment decisions away from the efficient outcome.

While the average cost of debt determined by ‘on the day’ or a historic average approaches may be broadly the same over the long run, the volatility created by adopting the former of these approaches may be detrimental to both consumers and NSPs in the short to medium term. As alternative methodologies for estimating the cost of debt that would mitigate problems of volatility and inefficiencies exist and are provided for in the Rules, SP AusNet considers that these should be further explored (see below).

Intent of the AEMC Rule Change

The AEMC’s Economic Regulation of Network Service Provider’s Rule change provides that, at each determination, the allowance for the cost of debt can be computed in one of three different ways:

- Clause 6.5.2(j)(1) sets the allowed return on debt to match a debt management strategy of raising all of the NSP’s debt finance at the beginning of each determination.
- Clause 6.5.2(j)(2) sets the allowed return on debt to match a debt management strategy of staggered borrowing (e.g., each year issuing 10% of total debt requirements via 10-year debt instruments).
- Clause 6.5.2(j)(3) sets the allowed return on debt to match a debt management strategy of staggered borrowing plus a swap overlay to hedge the base rate (but not the debt risk premium) to the rate that prevails at the beginning of the regulatory period.

SP AusNet considers it is clear from the AEMC’s commentary on this aspect of the Rule change that it is intended the Guidelines should consider multiple approaches. That is, the Guidelines should contain some consideration and explanation in relation to each of the three approaches that the AEMC has deemed to be acceptable and has codified in the Rules.

This appears optimal because it is yet to be established whether the best methodology for estimating return on debt is the same for benchmark efficient service providers with different characteristics. This approach also allows the regulator to maintain flexibility at this stage, and it will also provide all stakeholders with an opportunity to provide input into how each of the three approaches might be implemented.

Efficient financing practices

Each of the three methods codified in the Rules matches a particular debt management strategy.

SP AusNet has addressed the strategy of re-financing 100% of total debt requirements at the beginning of each determination (i.e., the strategy that matches clause 6.5.2(j)(1)). As described above, in many circumstances an efficient benchmark NSP would not (and indeed could not) refinance all of its debt requirements at the beginning of each regulatory period.

The strategy of staggered debt issuances with no swap overlay (the strategy that matches clause 6.5.2(j)(2)) is the strategy that may be employed by very large NSPs and has been extensively elaborated on by various State Government Treasury Corporations. However, SP AusNet considers this approach potentially could add additional administration and execution complexities.

The strategy of staggered debt issuances with a swap overlay matching the regulatory period (the strategy that matches clause 6.5.2(j)(3)) is used by the majority of private NSPs, including SP AusNet. While concern has been expressed that the depth of the interest rate swaps market may constrain this approach, in our experience, these markets are highly liquid transacting billions of dollars a day.

As the ENA submission outlines, in assessing the above strategies, the characteristics of the efficient and prudent financing practices that should be taken into account include:

- Managing refinancing risk;
- Enabling there to be sufficient timely new capital to fund new investments;
- Managing interest rate risk;
- For international portfolios of debt, managing exchange rate risks;
- Minimising the over-all costs by adopting optimal bond issue sizes, coupon rates, durations and transactions costs; and
- Optimal transition paths from any sub-optimal practices that were induced by the former regulatory arrangement to optimal practices going forward.

It is possible that not all benchmark efficient entities would manage the above considerations in exactly the same way, and it is not yet clear which alternative methods will best achieve the allowed rate of return objective.

Through addressing multiple approaches in the Guidelines, this would allow the AER to determine which debt management practice would be adopted by an efficient NSP, in the circumstances. The regulator would then select an approach from among the three allowed approaches that best matches the debt management practice of an efficient NSP.

It should also be highlighted that there are material differences in debt raising costs associated with each of these financing strategies. Consideration of these costs should be incorporated in the WACC Guidelines work stream.

Transitional issues

Given the materiality of the cost of debt allowance for both consumers and businesses, and particularly private businesses, careful consideration of transitional issues created from a network proposing to move from one methodology to another must constitute a key future stream of work for incorporation into the final Guidelines.

Customer feedback

Feedback from consumer groups will be vital during this process as there are likely to be material trade-offs between price volatility and price levels given the three methodologies above. As such, SP AusNet strongly endorses the AER decision to form a specific working group to deal with cost of debt issues.

Conclusion

In summary, the regulator should seek to determine the allowed cost of debt using the methodology commensurate with the debt management strategy an efficient NSP would employ in the circumstances of the particular NSP. This “matching” approach is consistent with the overall rate of return objective which requires that the allowed return must be commensurate with the efficient financing costs of the benchmark entity. It is also serves to minimize the difference between the allowed cost of debt and the actual benchmark efficient cost of debt, which will mitigate investment distortions, and contribute to achieving an efficient outcome.

As the AEMC provides for, different debt management strategies could be efficient for different NSPs. Therefore, the AER should maintain flexibility by considering each of the three approaches codified in the Rules in the forthcoming Guidelines.

I hope you find this document useful and should you have any questions in relation to these matters please contact Tom Hallam on 9695-6617.

Yours sincerely,

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