SP AusNet™
A member of Singapore Power Group

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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: Draft Rate of Return Guideline**

SP AusNet welcomes the opportunity to provide comment on the AER's draft Rate of Return Guideline. This response focuses on 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 Equity**

SP AusNet supports the ENA's submission on the cost of equity issues. However, we would like to highlight our concerns about the limited information the AER has provided to date around the equity beta and the market risk premium (MRP). These are key parameters under the AER's 'foundation model' approach, yet after ten months and three rounds of consultation the limited information that has been provided on the AER's proposed approach to estimating these parameters does not allow an indicative cost of equity to be estimated.

Regarding the MRP, it is not clear that the AER's approach will be clarified in the final guideline either. To enable stakeholders to form a reliable view on the likely cost of equity estimate that is likely to result from the AER's final Guideline, SP AusNet strongly supports the inclusion of a worked example in the final Guideline of the contemporaneous MRP estimate that would result were the AER to apply its proposed approach to estimating this parameter.

**Cost of Debt**

- **Trailing average and annual updating**

SP AusNet supports the trailing average approach set out in the draft guidelines. The inclusion of annual updating is necessary to allow NSPs to minimise the mismatch between the return on debt allowance and the actual return on debt.

NCS INTERNATIONAL CERTIFIED QUALITY MANAGEMENT SYSTEM ISO 9001
NCS INTERNATIONAL CERTIFIED SAFETY MANAGEMENT SYSTEM AS/NZS 4801
NCS INTERNATIONAL CERTIFIED ENVIRONMENTAL MANAGEMENT SYSTEM ISO 14001

This will also result in smoother prices for consumers, as changes to the cost of debt are gradually reflected in the allowance rather than aggregated and passed through at the beginning of the next regulatory control period.

- **Seven year benchmark term**

The AER has reduced the average term of debt for the benchmark firm from ten to seven years. The AER's rationale for this change is based on:

- The available evidence that suggests that the 'effective' average term of debt is less than 10 years (which takes into account the effect of 'swaps');
- The requirement that automatic updating of the trailing average portfolio return on debt is mechanistic; and
- The difference in term premium between seven and 10 years is not material.

SP AusNet strongly disagrees with each of these points. The AER has not considered the likely change in hedging practices under the trailing average benchmark. As pointed out by the Regulatory Development Branch (RDB):

> *'the use of swap contracts to lock in the cost of debt for the access arrangement is a consequence of the regulatory framework, and their use by regulated businesses would change if the regulatory framework were to change[1].'*

The RDB also commented that:

> *'…it is questionable whether a business needs to use any swaps if the regulator compensates the businesses using a portfolio approach that applies to the total cost of debt[2].'*

Under the current approach, most private NSPs (including SP AusNet) enter into swap contracts to hedge the cost of debt to the regulatory allowance. This is because swap contracts are the only way to hedge the current benchmark where an NSP staggers its debt issuances rather than refinancing the entire debt portfolio in a short period of time (resulting in unacceptable refinancing risk).

However, as the RDB explains, under a trailing average approach, the continued use of swap contracts is questionable. If an NSP implements the benchmark and refinances 1/10$^{th}$ of its debt portfolio each year (assuming a 10 year benchmark term), then the actual cost of that debt issue would be reflected in the benchmark in the next year, and remain part of the debt benchmark for 10 years until it reaches maturity. As the cost of debt is automatically incorporated in the benchmark, there is no need to enter into swaps to hedge the cost of this debt to the debt allowance.

The AER's concerns around annual updating being mechanistic and the perceived immateriality of the difference between the cost of debt with a seven year and ten year

[1] RDB, Estimating the Cost of Debt – A Possible Way Forward, April 2013, p.11
[2] *Ibid.,* p.25

term are ill founded and, therefore, are not consistent with the allowed rate of return objective. This specifies that *'the rate of return for a D/TNSP 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 D/TNSP in respect of the provision of standard control services'*.

In particular:

- There are times when the difference between 7 and 10 year cost of debt is material, particularly when markets are concerned with risk. In addition, the AER's analysis of materiality only considers the term premium of the debt risk premium component of the cost of debt. The term premium of the risk free rate component should also be considered.

- Reliable mechanistic approaches to extrapolation can be set out in a determination. The ENA and the QTC propose extrapolation methodologies that are suitable for this purpose.

The ENA submission addresses both of these concerns in detail.

- **Transition**

Provided the benchmark term returns to 10 years SP AusNet considers that the transition path presented in the draft Guideline is appropriate to allow businesses and customers to transition to the new cost of debt approach with no windfall gains and losses for either party.

- **Benchmark credit rating**

The benchmark credit rating should be forward-looking as it reflects the likelihood of an entity defaulting on its debt obligations. The current median credit rating (as at June 2013) is BBB. The AEMC express that it is desirable to establish 'the best estimate of the rate of return [that] can be obtained that reflects efficient financing costs of the service provider ***at the time of the regulatory determination***[8]. For this reason, the relevance of the AER's backwards-looking credit rating analysis is unclear. If the median credit rating of the benchmark firm sample comparators is currently BBB, this would appear to be the most appropriate credit rating to adopt as the benchmark.

## Conclusion

In summary, SP AusNet supports the AER's proposed approach to estimating the cost of debt set out in the draft Guideline, subject to returning to a ten year benchmark term of debt. This is consistent with the actual debt financing practices of the businesses the AER considers are sample comparators of the benchmark firm and will result in less volatile revenues and prices for customers.

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[3] AEMC, final rule change determination, p. iii

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