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Dear ██████████,

Thank you for the opportunity to comment on the *Energy network debt data* working paper. The addition of the working paper series to the rate of return instrument consultation process is a welcome development. We look forward to engaging with the AER and other stakeholders throughout the process.

We agree that the collection and presentation of aggregated actual debt data is useful for the AER and stakeholders to observe whether the benchmark allowance is a reasonable estimate of debt costs. However, we do not believe that the Energy Infrastructure Credit Spread Index (EICSI) should be directly used to set benchmark debt allowances.

In our view, the cost of debt benchmark should have the following characteristics:

- Independence;
- Transparency;
- A balance between sustaining long-term financeability and cost efficiency; and
- Be reflective of broader market conditions for raising debt capital.

The EISCI doesn't meet these criteria for several reasons:

- The methodology is still being refined and has numerous shortcomings that that make it an unreliable benchmark
- Factors that lead to actual debt outcomes causing a deviation from the current benchmark are not considered
- The EICSI is historical and does not reflect the prevailing cost of debt, and the credit ratings do not reflect future circumstances
- The method used to calculate the EICSI is not transparent.

These reasons are considered in more detail below. More analysis is provided in the ENA submission, which Ausgrid supports.

Methodological issues

We have some concerns with the methodology used to calculate the EICSI that have not been resolved since its first publication.

The EICSI does not weight or adjust raw cost of debt data across the industry in order to produce a 'pure' unadjusted index. The EICSI approach is an informative starting point but has significant weaknesses when considered as a benchmark for cost of debt. Key characteristics such as debt maturity profile, average cost margins and refinancing requirements will vary considerably across the range of different debt portfolios in the industry. The simple average approach used in calculating the EICSI will have a consistent bias towards underestimating the cost of debt. This results from the skew in the distribution of debt sizes across the industry.

A better estimate for actual cost of debt (issued or held) across the industry is the debt weighted average. This also holds true for the other industry benchmark outputs which are of interest such as term of debt and credit rating.

The draft working paper compares cost of debt derived by the AER benchmark versus the EICSI and points out that the EICSI is consistently lower of the two approaches. This is in large part a result of the skew in the EICSI towards short term and small to medium-sized debt which will have lower term to maturity and credit spreads. On this basis, a simple average benchmark would risk consistently underestimating the allowance needed to be able to refinance and fund large debt portfolios on an ongoing basis. In the most extreme case, it could risk allowances falling critically below long-term financeability levels. Given there is a large range in debt sizes across the industry, weighting needs to be introduced to the index.

Another factor contributing to the discrepancy described above is the use of original debt allowance rather than actual debt allowance after actual inflation has been applied.

The EICSI, having a membership that is relatively low in number and of a diverse range in size, lacks the breadth required to be a reliable index. This raises issues of equity and independence. By forming a nexus between the benchmark and the financing activity driving it, there could be the potential for networks to influence the benchmark outcomes which would compromise the benchmark regime.

Factors affecting actual debt outcomes

There is an assumption that the EICSI represents the efficient financing practices of the firms in question. This assumption fails to consider the individual circumstance of each business.

For example, before the partial long-term lease of Ausgrid the whole debt book was converted to short term bank debt. After the sale, management had to very quickly refinance to a more reasonable and lower risk portfolio. Given the scale of debt it was not possible to immediately implement what would be considered an efficient, long term strategy. Ausgrid is still in the process of moving to its optimal strategy, therefore our average cost of debt that is contributing to the EICSI is not something we, or any other network, should be expected to replicate as a benchmark portfolio. This demonstrates that the EICSI history is not long enough and would contain anomalies of capturing an industry debt financing process which is still evolving towards a long-term maturity profile.

There are a number of other important factors that impact issuance tenor and pricing that result in outcomes that differ from the benchmark. These include demand side factors (willingness of investors or banks to lend at a particular time) and offshore issuances that affect domestic markets. While demand side factors affect all issuances, continuing to use the published indices from Bloomberg, Reserve Bank of Australia (RBA) and Thomson Reuters means the demand side effects are spread across all rated issuances. This is more representative of outcomes for the whole market, rather than the small number of businesses and issuances included in the EICSI.

De-linking to prevailing cost of debt

The draft working paper notes that the EICSI is intended to be updated annually. However, not all utilities issue annually, and to make sure that return on debt is calculated as close as possible to the end of the averaging period it might need to be updated continuously¹.

Without a broader base of inputs the index could have years where it fails to represent real market conditions and/or a very limited number of issuances heavily influence the outcome. An averaging period becomes irrelevant if the EICSI were to be used on its own to set debt costs.

Use of historic credit ratings may also be misleading as this does not take into account the prevailing conditions for debt issuances made in the future. The whole compensation framework should be considered, and the benchmark credit rating aligned to this through consideration of overall financeability.

Transparency

The data underlying the EICSI is highly sensitive and confidential. The ability of networks to forecast debt costs with any degree of comfort if the EICSI index was used to benchmark debt costs would be lost. Currently, a forward yield curve can be used to estimate long term benchmark debt costs, but there is no way to know how the EICSI might move over time as the EICSI will be influenced by the financing decisions of a small numbers of networks over time. Further, other stakeholders will also find it difficult to understand how the debt costs might move over the course of a regulatory period and beyond.

Other issues

The AER collected debt raising costs (DRC) and is proposing to use them when it comes to setting opex in regulatory decisions². However, there is an interaction between DRC and spreads in the EICSI.

The spreads on short term bank debt are generally lower than alternative instruments, however other fees are incurred that are considered DRC (for example explicit issue ratings where markets or investors require two note ratings). This means some networks may have lower spreads and higher DRC, and vice versa. It is not clear whether this would be a consideration if EICSI was used to set debt costs and how the interaction with DRC would be captured.

¹ AER, Energy network debt data: Draft working paper, June 2020, p19.

² AER, Energy network debt data: Draft working paper, June 2020, p18.

If a change is made to the current benchmark methodology it is important to consider all possible consequences. For example, a shorter dated index would lead to an increase in shorter tenor issuance and an increase in maturity profile concentrations leading to increased refinancing risk, weakened tolerance to shocks and increased bank and bond pricing levels.

We look forward to continued engagement with you and all stakeholders throughout the rate of return instrument review. If you have any questions regarding this submission please contact

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Regards,

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Chief Customer Officer