14 August 2020

Mr [redacted]
General Manager, Networks Finance and Reporting
Australian Energy Regulator
GPO Box 520
MELBOURNE VIC 3001

Email: [redacted]

Dear [redacted]

Energy Debt Data Draft Working Paper

This submission has been prepared by:

- Australian Gas Infrastructure Group;
- SA Power Networks;
- United Energy; and
- Victoria Power Networks.

We welcome the opportunity to respond to the Australian Energy Regulators' (AER) draft working paper on *Energy Network Debt Data*. We look forward to further constructive engagement with stakeholders throughout the remainder of this important process.

We actively participated in the preparation of the Energy Networks Australia (ENA) and Australian Gas and Pipeline Association (AGPA) submissions to this process and fully endorse those submissions.

This letter highlights matters that we consider to be of particular importance.

Known deficiencies – with the EICSI index

The ENA submission sets out several material deficiencies with the current construction of the EICSI index, including for example:

- the index gives ten times as much weight to one-year debt as it gives to ten-year debt;
- the index gives the same weight to a $1m bank loan as to a $500m bond issuance; and
- the index includes only a subset of the costs in relation to bank loans.

These issues were raised with the AER in the 2018 review but have not yet been addressed. The ENA submission also identifies a number of additional issues, some of which appear to have no clear or simple solutions.

These issues require full and transparent consideration to enable stakeholders to have confidence in the EICSI index.

Implementation issues

The AER's benchmark efficient financing strategy can be replicated in practice (putting aside the treatment of inflation) and we typically attempt where possible to do this. We do so because we agree with the AER that this represents a prudent and efficient approach to managing our debt financing requirements.

A regulatory allowance based on the EICSI approach would be impossible to replicate as the index can only be computed in arrears.

Our view is that it is not appropriate for the AER to set a benchmark efficient regulatory allowance based on an approach that is not possible for any network to implement.

Distorts incentives to the detriment of consumers

We endorse the ENA and APGA submissions in relation to the potential incentive effects of moving from an independent third-party data source to a regulatory allowance based on network data.

We note that, under the current approach, the AER currently determines what it considers to be the benchmark efficient financing approach and sets the regulatory allowance accordingly. Networks are free to deviate from the benchmark efficient strategy if they choose, but any such deviation has no impact on the regulatory allowance, consumers will only ever pay according to the AER's estimate of the benchmark efficient financing cost, and networks bear 100% of the cost and risk that comes from any departure from the benchmark efficient strategy.

By contrast, if the regulatory allowance is based on the industry data, any deviation by a network from the benchmark efficient financing approach *does* impact the regulatory allowance. This creates unnecessary strategic interdependence between networks in respect of debt strategies and consumers pay any costs associated with this, even if those strategies differ materially from what is prudent and efficient.

Businesses have been materially under-compensated over the last five years, but the Draft Working Paper invites the opposite conclusion

The interaction between the AER's approaches to regulatory inflation and cost of debt mean that the AER's estimate of the benchmark efficient cost of debt has not been delivered to networks over the last several years.

This is because the AER deducts its estimate of expected inflation from its return on debt allowance and then adds back actual outturn inflation. Over the last several years, the AER has deducted approximately 1% more than it has added back. But network debt is fixed in nominal terms in which case the regulatory regime has delivered a return that is 1% lower than the efficient cost.

The ENA submission (Figure 5) demonstrates that the industry debt data shows that regulatory compensation to network businesses has been below the actual cost of debt incurred by a network following the AER's benchmark efficient debt management approach.

By contrast, Figure 1 of the Draft Working Paper shows an historical comparison of two series that are labelled "Industry Index" and "AER history," respectively. This shows a persistent and often large gap between the two series that appears to invite the conclusion that networks have typically been overcompensated for the cost of debt issued over this period.

This is not the case and should be made clear in future presentations of this data.

Even if the 10-year forecast inflation is correct, then under current economic conditions businesses will still receive less than their efficient nominal debt costs as determined by the AER.

It is important that, throughout this consultation process, all stakeholders have a proper understanding of the regulatory allowances that have been made to networks.

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We endorse the key conclusions of the ENA and APGA submissions:

- It is appropriate for network debt data to be used to test in broad terms whether;
  - (a) the AER's assumption about the prudent and efficient debt management approach (ie issuing 10-year BBB+ debt on a staggered maturity basis); and
  - (b) the cost of that benchmark efficient approach as delineated by a mix of third-party indices used to determine the cost of debt allowance remains fit for purpose.
- It would be inappropriate to apply any weight to the EICSI when setting the allowed return on debt, given the various issues which exist with it, some of which appear to be more substantive than can be remedied by fine-tuning the indices.

The businesses look forward to working constructively with the AER in an open and transparent process to arrive at an outcome for regulatory debt allowances that promotes investment in the long-term interests of consumers. Please contact [redacted] or [redacted] if you would like to discuss this submission further.

Yours sincerely

[redacted]
General Manager – People and Strategy
Australian Gas Infrastructure Group

[redacted]
General Manager Governance and Regulation
SA Power Networks

[redacted]
General Manager Regulation
United Energy and Victoria Power Networks