14 August 2020

Mr. Warwick Anderson
General Manager Networks Finance and Reporting
Australian Energy Regulator

Via website: rateofreturn@aer.gov.au

Re: Energy network debt data draft working paper

Spark Infrastructure welcomes the opportunity to respond to the AER's draft working paper on energy network data as part of its process for developing the 2022 Rate of Return Instrument (**RORI**).

We understand that the paper is proposing to develop an Energy Infrastructure Credit Spread Index (**EICSI**) which aims to represent the actual debt costs of Network Service Providers (**NSPs**) and seeks views on how that might be used in developing the 2022 RORI.

It appears that the AER is seeking to modify its approach to estimating the efficient cost of debt without first ensuring that the revenue models actually provide sufficient revenue to compensate NSPs for the estimate of efficient debt costs. Once this can be confirmed, then modifications to the approach to estimating the efficient cost of debt can be assessed.

To ensure the revenue models calculate compensation that reflects the estimated efficient cost of debt, the AER should:

- **Ensure that the treatment of inflation in the revenue models** (the post-tax revenue model (**PTRM**) and the roll-forward model (**RFM**)) is congruent with the method for estimating the efficient cost of debt.
- **Undertake a financeability assessment** to ensure that the credit rating (currently BBB+) assumed in estimating the efficient cost of debt can, ex-ante, be expected to be achieved and maintained by an efficient NSP adopting the benchmark assumptions without support from: regulatory incentives; unregulated activities; other businesses or services provided by the parent that controls the regulated NSP's activities; or from a parent company 'halo' provided to the rating, given the compensation provided. Credit ratings of consolidated entities include the benefits of these types of support.

The RORI sets out the method for estimating the efficient cost of debt in nominal terms. The current treatment of inflation in the PTRM and RFM does not provide compensation for the estimate of the efficient cost of debt because the amount of inflation removed from the RAB is based on a forecast and the amount of inflation added back is based on actual inflation. As is revealed in Energy Networks Australia's (**ENA's**) presentation to the AER's debt forum on 29 July 2020 (see chart on next page), compensation for debt has not matched the AER's benchmark cost of debt or costs represented by the AER's EICSI index.

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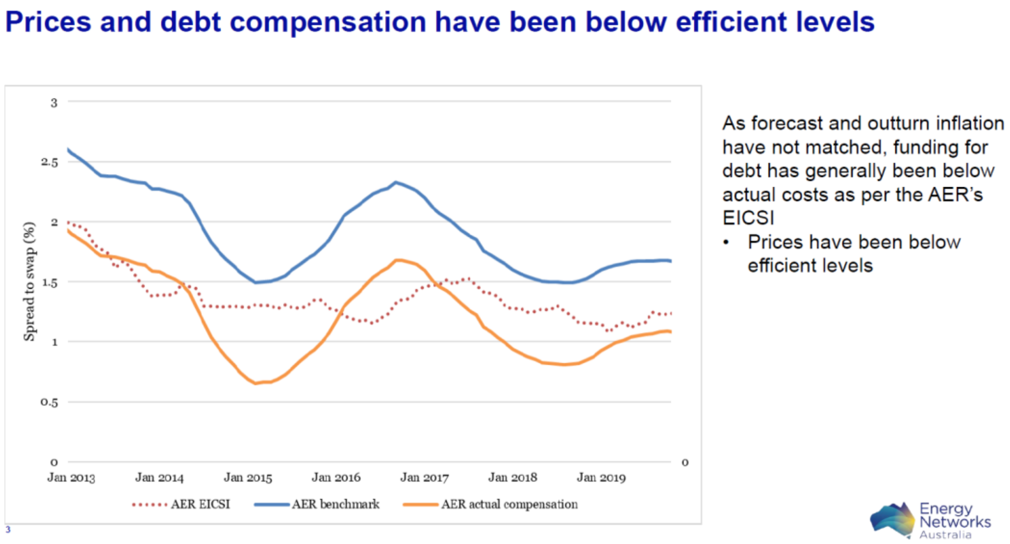

[3]

The weighted average cost of capital determined under the RORI is based on benchmark financing assumptions for a benchmark efficient entity. This includes a benchmark gearing of 60:40, benchmark credit rating of BBB+ and yield based on the average of 10-year RBA/Bloomberg/Reuters yields (one third broad A band and two thirds broad B band).

If an efficient NSP cannot achieve or maintain the benchmark credit rating, or, actual debt data indicates that the credit rating is not being achieved, then the compensation is wrong and must be addressed. Revising the benchmark credit rating because it cannot be achieved is circular and unsustainable given the dependence of the credit rating on compensation provided by the AER's models. This will impact on the ability to attract and undertake efficient levels of investment.

It does not make sense that an efficient NSP must be expected to depart from one benchmark assumption (e.g. gearing) to achieve another (e.g. credit rating). This would be like a bank that approves a home loan application based on the income an applicant could earn rather than the income that they do earn. The NSP has no other avenue to raise revenue and should not be expected to leverage related (unregulated) services and entities to remain viable. It is inconsistent with ring-fencing principles (and requirements) for the NSP to rely on subsidies between regulated and unregulated activities or leverage the diversification or 'halo' of a parent entity to achieve the efficient cost of debt assumed by the AER (and set out in the RORI).

We do not support a change to the approach to estimating the efficient cost of debt. Introducing a new approach to estimating the efficient cost of debt with no identifiable benefits when many businesses remain part way through transitioning from one historical approach to another historical approach results in instability and unpredictability that does no more than introduce risk and cost.

Resolving these critical inconsistencies and errors that directly affect incentives to invest should be a primary focus before refinements and change are contemplated. Nevertheless, assuming these issues are resolved, the appropriate specification and use of a debt index must recognise and account for:

- **The role of benchmarks in cost estimation.** Different NSPs will, for a range of reasons, pursue different debt management strategies to seek to outperform the benchmark. This should not be cause for concern or prompt a change because customers continue to benefit from competition in the market for debt and do not bear the cost of strategies that are not successful in outperforming the benchmark. Nevertheless, if an NSP chooses to match the regulatory benchmark assumptions, it should be able to remain financially viable and achieve and maintain the benchmark credit rating and meet its regulatory assessed cost of debt. Reported actual costs can include a subsidy or additional cost from diversification, parent support or the cost of inefficient financing practices.

- **The difference between an average and a benchmark**. A benchmark represents the expected efficient cost of debt. An average reveals no information about efficiency. Some NSPs may depart from the benchmark for reasons of their own while others do not. This may reflect unique circumstances that affect the options available to it. However, if an average is applied as a benchmark, there will always be some NSPs that are unable to recover costs because they are higher than the average even when those costs are consistent with efficient benchmarks.
- **The difference between backward-looking and forward-looking.** Backward-looking data shows what historical costs may have been in those historical market conditions and reveals no information at all about efficient costs in prevailing or future market conditions for which costs are being estimated. Further, where there is a change to the approach for estimating the efficient cost of debt, for example in the RORI and subsequent determination, NSPs can seek to match that approach to reduce regulatory risk making the use of a historical index that relates to a different debt approach irrelevant and unhelpful.

We maintain that it is in the best interests of consumers to continue an incentive-based approach to regulation that provides NSPs with compensation for benchmark efficient costs. This allows an NSP to depart, at its own risk, from the benchmark and ensures customers do not wear the losses if that strategy is ultimately unsuccessful. The ability for NSPs to retain the benefit, and bear the risks, of attempting to outperform the benchmark improves the ability of the NSP to attract debt and equity capital and retain an incentive to invest. Before these important incentive properties are broken or weakened, we recommend that the AER assess the impact of a change in incentives on investment and the long-term interests of consumers.

The current rates of return and inflation treatment do not support the benchmark gearing or provide a return to equity holders consistent with that set out in the RORI. The analysis presented by TransGrid to the AER's review of the regulatory treatment of inflation illustrates the impact on credit ratings under current regulatory settings and the potential risk to investment if not addressed.[1]

In short we do not see that developing an Energy Infrastructure Credit Spread Index is required or beneficial to determining efficient debt costs for benchmark NSPs, especially where there are clearly obvious fundamental errors and inconsistencies in the revenue models that are not in the long-term best interests of consumers and need to be addressed as a matter of urgency.

We consider a shared understanding of these issues would benefit subsequent stages of the RORI 2022 review process and recommend that the AER host a forum for NSPs, investors and consumers to understand credit metrics, the relationship with credit ratings and benchmark terms, and work through some case studies.

I would be happy to discuss these matters further and can be contacted on 0421057821.

Yours sincerely,

S McMahon

Sally McMahon
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Spark Infrastructure

[1] TransGrid, Response to 2020 Inflation Review – Discussion Paper, 3 August 2020.

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