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Mr Alex Oeser
Australian Energy Market Commission
PO Box A2449
Sydney South NSW 1235

Lodged online

Dear Mr Oeser,

Ausgrid welcomes the opportunity to comment on the AEMC's draft determination (draft determination) regarding the participant derogation rule change proposals lodged by TransGrid and ElectraNet for the financeability of integrated system plan (ISP) projects.

The national electricity market (NEM) is amid an unprecedented transformation which has the potential to change the way customers use energy, drive down prices for customers and contribute to the decarbonisation of the Australian economy. It is critical that the right policy settings are in place for networks to respond to this energy transformation and provide customers with these desired outcomes.

While the draft determination did not find that a rule change was necessary in the specific cases put forward by Transgrid and Electranet, it did explore financeability issues generally that we wish to address.

Wider issue of financeability remains unresolved

While noting the options available to Transgrid to maintain its credit rating (and thus its financeability), CEPA recognised that it would be difficult to implement these under the current regulatory framework due to the constraints of the single rate of return instrument.[1] This could potentially be resolved through the AER's consultation on financeability in its rate of return instrument (RORI) process. We believe it is good policy to have a formal financeability framework in place, noting that there are precedents for this both overseas and domestically.

The draft determination relies on the following assumptions in concluding that the regulatory framework does not create a barrier for ISP investments:

- the capital structure of businesses should be flexible over fluctuating growth and investment cycles
- other measures such as taking no distributions, reducing opex and reducing or delaying capex can be used to manage credit rating risk.

We are keen to understand the assumed boundaries of these proposed options (both timing and scale), and intend to raise these issues as part of the AER's RORI process.

[1] CEPA, Financeability of ISP projects, 27 January 2021, p 52.

Inflation-linked finance is not a realistic option

One of the remedies suggested by CEPA that could assist businesses with financeability issues is to make use of other financial products, for example inflation-linked finance and hybrid securities. Use of index-linked finance has been raised in other forums, for example the AER's inflation review[2], and appears to be unresolved. The table below reflects Ausgrid's response to the evidence discussed by CEPA[3] on this topic.

CEPA assertion	Does assertion support inflation-linked finance/hybrid as a viable and efficient option for networks?
Most inflation linked securities are issued by the Commonwealth Government	× - Commonwealth Government accounts for c. 90% of inflation-linked securities in the market. **Since 2010 there have been no corporate inflation-linked issuances.**
There are 39 inflation linked corporate bonds issued	× - the most recent corporate issuance was in 2010, by the University of Wollongong for $20 million. As noted above, since 2010 there have been no corporate inflation-linked issuances, but approximately $110 billion in nominal senior corporate bond issuances (excluding bank and financials). **The total inflation linked corporate issuance in the market over the last 20 years is less than one third of Ausgrid's total debt.**
Major companies that have issued capital linked bonds are Sydney Airport and Commonwealth Bank of Australia (CBA)	× - **these issuances were pre- global financial crisis in 2006 and 2007** respectively when inflation, interest rate and market conditions were markedly different. The CBA issuance was for $150 million, an extremely insignificant percentage of CBA's total debt issuance since, indicating it was not part of a broader inflation risk mitigation strategy nor is it a viable funding alternative currently.
There is a preference for higher rated bonds by investors who seek this type of exposure, which does not match with the lower investment grades of energy networks	× - there has only been Commonwealth Government issuances since 2010. This supports the view that inflation-linked finance is not an efficient financing option for energy networks.
The low liquidity means credit margins may be higher than for an equivalent tenor nominal bond	× - in Ausgrid's experience the credit margins are higher for inflation linked than for an equivalent tenor nominal bond. This supports the view that inflation-linked finance is not an efficient financing option for energy networks.
The AER allowance is based on nominal bonds, so index linked finance increases the residual risk borne by shareholders	× - this supports the view that inflation-linked finance is not an efficient financing option for energy networks.
An insurance wrapper to increase the credit rating of an issuance is effectively	× - this supports the view that inflation-linked finance is not an efficient financing option for energy networks.

[2] AER, Draft position: Regulatory treatment of inflation, October 2020, p80.
[3] CEPA, Financeability of ISP projects, 27 January 2021, pp 48-49.

CEPA assertion	Does assertion support inflation-linked finance/hybrid as a viable and efficient option for networks?
impossible to obtain since the global financial crisis	
Appropriate investors would have interest in such securities, and that use of swap markets provides an alternative way of accessing the market	✗ - this statement is unsubstantiated and is incongruent with the lack of corporate issuance in over a decade. It would be beneficial if CEPA could elaborate on this comment with some evidence as to how the understanding was formed, including tenors and potential issuance volumes.
Lack of available issuance to invest in means there is a lack of familiarity with such products	✗ - this statement is unsubstantiated. A lack of corporate issuance does not indicate a lack of familiarity with such products. Our discussions with banks indicate that Australian investors are simply not interested in this type of product in meaningful volumes.
Hybrid securities can be used to manage interest costs and gearing	✗ - hybrid securities are generally rated 2 notches lower than the corporate rating, so for B bracket firms cost substantially more than senior secured debt and have a detrimental effect on cash flow and interest cover metrics. Realistically only a viable option for A bracket ratings, thus a limited number of network businesses.

After making the above assertions, it is concluded by CEPA that index-linked finance and hybrid securities are reasonable options for network businesses. We do not agree that this is a reasonable conclusion to draw from the evidence presented or from our own experience, particularly in the case of index-linked finance. As noted above, the opposite conclusion – that index-linked finance is not a reasonable option for networks – is more readily drawn from market activity over the past 10-20 years. If there was pent up, or any, demand for low investment grade inflation-linked bonds or derivatives, the signals would be evident within the market and supply would be forthcoming.[4]

Ausgrid has discussed the possibility of issuing inflation linked bonds and entering contracts for inflation derivative instruments with a range of brokers and banks domestically and offshore. There are limited secondary price makers and we are generally unable to obtain comparable pricing for derivative instruments in any significant volume or tenor due to a lack of counterparties and inflation trading desks. Given the reliance by the AEMC on this aspect of the CEPA report we consider it important that the AEMC makes due inquiries with CEPA to address the points we raise in this submission and outline its findings in the final determination. If you have any queries in respect of this submission, please contact Fiona McAnally on 02 9160 3730 or fiona.mcanally@ausgrid.com.au.

Regards,

Rob Amphlett Lewis
Chief Customer Officer

[4] An example of markets responding to match supply and demand is the Sydney University A$200 million issue in response to Korean long- dated demand in 2018 and 2019.