

27 February 2014

Mr. Andrew Reeves
Chairman
Australian Energy Regulator
GPO Box 3131
Canberra ACT 2601

Dear Mr. Reeves,

Ausgrid, Endeavour and Essential cost of debt averaging periods

I am writing in response to your letters regarding averaging periods to be used to set cost of debt allowances for the NSW Distribution Network Service Providers, Ausgrid, Endeavour Energy and Essential Energy (the NSW DNSPs) over the 2014-15 to 2018-19 regulatory control period. The NSW DNSPs support the AER's decision to use the trailing average approach to estimating the cost of debt for regulated energy network firms.

The trailing average approach will markedly reduce volatility in rate of return allowances and as a result will also reduce volatility in energy network bills. As noted by the AER throughout the rate of return guidelines process, in the presence of re-financing risk the benchmark efficient debt management approach is to issue debt on a staggered portfolio basis. A trailing average approach estimates the cost of debt for a firm that manages its debt on a staggered portfolio basis.

The NSW DNSPs have managed their debt using a staggered portfolio approach and as a result would not face any difficulty transitioning to the trailing average approach. The NSW DNSPs propose an immediate transition to the trailing average approach.

I recognise that other businesses have attempted to match their actual costs of debt with the regulatory allowances under the short term averaging period approach. In some cases, businesses have aligned the maturity of their debt portfolios to the end of their regulatory control periods. In other cases, businesses have used hedging instruments to align their cost of debt allowances to interest rates prevailing at the start of their regulatory control periods. This has exposed these businesses to interest rate risk and re-financing risk. For these businesses a transitional approach may be appropriate to reduce the risk of under or over-compensation under the trailing average approach.

In contrast, to transition the NSW DNSPs from the previous short term averaging period approach to the trailing average approach would expose these businesses to significant interest rate mis-match risk. If prevailing rates over the AER's short term averaging period are lower than the historic costs of issuing debt, the NSW DNSPs would be under-compensated. This is inconsistent with the Revenue and Pricing Principles outlined in section 7A of the National Electricity Law, which require that DNSPs are given an opportunity to recover at least their efficient costs of providing standard control services.

If prevailing rates over the AER's proposed averaging period are higher than the historic costs of issuing debt, then the NSW DNSPs would be over-compensated relative to their

benchmark efficient costs of debt, with customers funding the difference through higher electricity network prices.

Consistent with an immediate transition to the 10 year trailing average cost of debt, Attachment 1 to this letter outlines the proposed averaging periods for each annual cost of debt observation to be applied in the AER's 2014-19 regulatory determinations for Ausgrid, Endeavour Energy and Essential Energy.

The NSW DNSPs propose to rely on cost of debt data recently published by the Reserve Bank of Australia (RBA). The RBA is an independent third party to the regulatory determination process and has published monthly corporate bond yield observations back to January 2005.

We propose that where possible each annual averaging period would span 12 months, from January to December each year. While it is not necessary to average each annual observation over the entire year, this is likely to be the most stable approach. In addition, having the annual cost of debt update available in early January each year would provide sufficient time for each business to incorporate the relevant annual update to the cost of debt along with updated CPI in its annual pricing proposals.¹

In implementing the trailing average approach to the cost of debt, historical bond yield data from the RBA is available from January 2005. This allows for 9 annual observations from January 2005 to December 2013. The NSW DNSPs have sought independent advice on how best to utilise the RBA data to estimate a 10 year trailing average cost of debt. We have been advised that the simplest and most practical solution is to use RBA data for the 9 years that is available and use independently published data from Bloomberg to estimate the yields on 10 year BBB bonds for the period January 2004 to December 2004.

This combination provides a 10 year trailing average estimate that ends in December 2013 and constitutes a starting point from which annual updates can be applied in each regulatory year from 2014-15 to 2018-19. A benefit of this approach is that the Bloomberg 2004 data would only be required in 2014/15 and, as the oldest 1/10th of the observations would fall away each year, the 10 year trailing average in all other years would be based on a full year of RBA observations. The NSW DNSPs' proposed averaging periods are outlined in Attachment 1 to this letter.

Prospective averaging periods

The AER has requested that the NSW DNSPs outline averaging periods that are prospective, that is forward looking. This is clearly inconsistent with a trailing average approach to setting the cost of debt, which by its nature relies on historic data. As noted above, for businesses that have issued debt on an efficient staggered portfolio basis, a trailing average estimate reflects a benchmark efficient cost of debt and is therefore the approach supported by the NSW DNSPs.

¹ I note that the timetable for annual pricing proposals is currently subject to review by the AEMC and may be brought forward from the current April deadlines each year.

However, if the AER decides to apply a short-term averaging period and transition to a trailing average cost of debt over the two regulatory periods, which would not see the transition complete until 2024/25, we recommend that the AER incorporate the maximum amount of data available in its annual averaging periods. This approach would help to minimise the impact of short term unexpected movements in debt markets while maintaining prospective observations.

In contrast, if a 20-day averaging period was adopted and abnormal market events occurred, increased volatility in pricing would occur, which is one of the principles that the trailing average was designed to address by taking a longer term view consistent with issuing debt on a staggered portfolio basis .

Although the NSW DNSPs do not support the AER applying a short term averaging period and transitional approach, if the AER applies such an approach, we recommend that the maximum number of observations from RBA be used, with the first observation to be from 28 February 2014 to 30 June 2014. The 2015-16 annual update would use RBA data from 1 July 2014 to 31 December 2014. From 2016-17 onwards, each annual update would use RBA data from 1 January to 31 December. This approach is outlined in Attachment 2.

I reiterate that if the AER applied a transition to the trailing average approach to calculating the cost of debt for the NSW DNSPs, this would be inconsistent with the Revenue and Pricing Principles outlined in section 7A of the National Electricity Law, which require that DNSPs are given an opportunity to recover at least their efficient costs of providing standard control services.

If you would like to discuss this matter further, please contact Mr Mike Martinson, Group Manager Network Regulation at Networks NSW on (02) 9249-3120 or via email at michael.martinson@endeavourenergy.com.au.

Yours sincerely,



Vince Graham

Chief Executive Officer

Ausgrid, Endeavour Energy and Essential Energy

Attachment 1 – Proposed cost of debt averaging periods for Ausgrid, Endeavour Energy and Essential Energy

Ausgrid, Endeavour Energy and Essential Energy – Proposed cost of debt averaging periods														
2014-15			2015-16			2016-17			2017-18			2018-19		
Averaging period		Wt	Averaging period		Wt	Averaging period		Wt	Averaging period		Wt	Averaging period		Wt
Start	End		Start	End		Start	End		Start	End		Start	End	
1/01/2004	31/12/2004	10%	1/01/2005	31/12/2005	10%	1/01/2006	31/12/2006	10%	1/01/2007	31/12/2007	10%	1/01/2008	31/12/2008	10%
1/01/2005	31/12/2005	10%	1/01/2006	31/12/2006	10%	1/01/2007	31/12/2007	10%	1/01/2008	31/12/2008	10%	1/01/2009	31/12/2009	10%
1/01/2006	31/12/2006	10%	1/01/2007	31/12/2007	10%	1/01/2008	31/12/2008	10%	1/01/2009	31/12/2009	10%	1/01/2010	31/12/2010	10%
1/01/2007	31/12/2007	10%	1/01/2008	31/12/2008	10%	1/01/2009	31/12/2009	10%	1/01/2010	31/12/2010	10%	1/01/2011	31/12/2011	10%
1/01/2008	31/12/2008	10%	1/01/2009	31/12/2009	10%	1/01/2010	31/12/2010	10%	1/01/2011	31/12/2011	10%	1/01/2012	31/12/2012	10%
1/01/2009	31/12/2009	10%	1/01/2010	31/12/2010	10%	1/01/2011	31/12/2011	10%	1/01/2012	31/12/2012	10%	1/01/2013	31/12/2013	10%
1/01/2010	31/12/2010	10%	1/01/2011	31/12/2011	10%	1/01/2012	31/12/2012	10%	1/01/2013	31/12/2013	10%	1/01/2014	31/12/2014	10%
1/01/2011	31/12/2011	10%	1/01/2012	31/12/2012	10%	1/01/2013	31/12/2013	10%	1/01/2014	31/12/2014	10%	1/01/2015	31/12/2015	10%
1/01/2012	31/12/2012	10%	1/01/2013	31/12/2013	10%	1/01/2014	31/12/2014	10%	1/01/2015	31/12/2015	10%	1/01/2016	31/12/2016	10%
1/01/2013	31/12/2013	10%	1/01/2014	31/12/2014	10%	1/01/2015	31/12/2015	10%	1/01/2016	31/12/2016	10%	1/01/2017	31/12/2017	10%

Attachment 1 – Proposed cost of debt averaging periods for Ausgrid, Endeavour Energy and Essential Energy



Attachment 2 – Cost of debt averaging periods under AER transition to trailing average cost of debt

AER transition approach averaging periods											
2014-15			2015-16			2016-17			2017-18		
Averaging period		Wt	Averaging period		Wt	Averaging period		Wt	Averaging period		Wt
Start	End		Start	End		Start	End		Start	End	
28/02/2014	30/06/2014	100%	28/02/2014	30/06/2014	90%	28/02/2014	30/06/2014	80%	28/02/2014	30/06/2014	70%
			1/07/2014	31/12/2014	10%	1/07/2014	31/12/2014	10%	1/07/2014	31/12/2014	10%
						1/01/2015	31/12/2015	10%	1/01/2015	31/12/2015	10%
									1/01/2016	31/12/2016	10%
									1/01/2017	31/12/2017	10%

