

21 August 2014

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

Dear Mr. Reeves,

Further data on actual costs of debt for the NSW DNSPs - [REDACTED]

Thank you for providing the opportunity to present to the AER Board on 1 August 2014 on the Ausgrid, Endeavour Energy and Essential Energy (the NSW DNSPs') regulatory proposals for the 2014-19 regulatory period. We appreciate the AER's commitment to engaging with the network businesses as part of the current regulatory determination and for the opportunity to set out those matters that are of utmost importance to the NSW DNSPs.

Further to our discussion regarding the appropriate regulatory allowance for the cost of debt, this letter sets out some initial information on the NSW DNSPs' actual costs of debt relative to both the trailing average cost of debt and the AER's proposed transition to the trailing average.

Throughout the rate of return guideline development process, the AER correctly identified that the efficient debt management approach in the presence of refinancing risk is to issue long-term debt on a staggered portfolio basis. The trailing average approach mirrors the efficient staggered portfolio approach to debt management undertaken by the NSW DNSPs and, as such, the NSW DNSPs support the adoption of the trailing average approach to setting the regulatory allowance for the cost of debt. As discussed on 1 August 2014 and as contained in the NSW DNSPs substantive regulatory proposals, are seeking an immediate move to the trailing average and do not support the AER's proposed transition to the trailing average as outlined in the rate of return guideline.

The NSW DNSPs have consistently issued debt using a benchmark efficient staggered portfolio approach and this has resulted in an actual cost of debt that closely mirrors the trailing average estimate of the cost of debt. In contrast, applying the transition approach to setting the cost of debt would significantly under-compensate the NSW DNSPs over the 2014-19 regulatory period (based on RBA estimates of the cost of debt between February and June 2014). This under-compensation would occur precisely because the NSW DNSPs have managed their debt efficiently, using a staggered portfolio strategy.

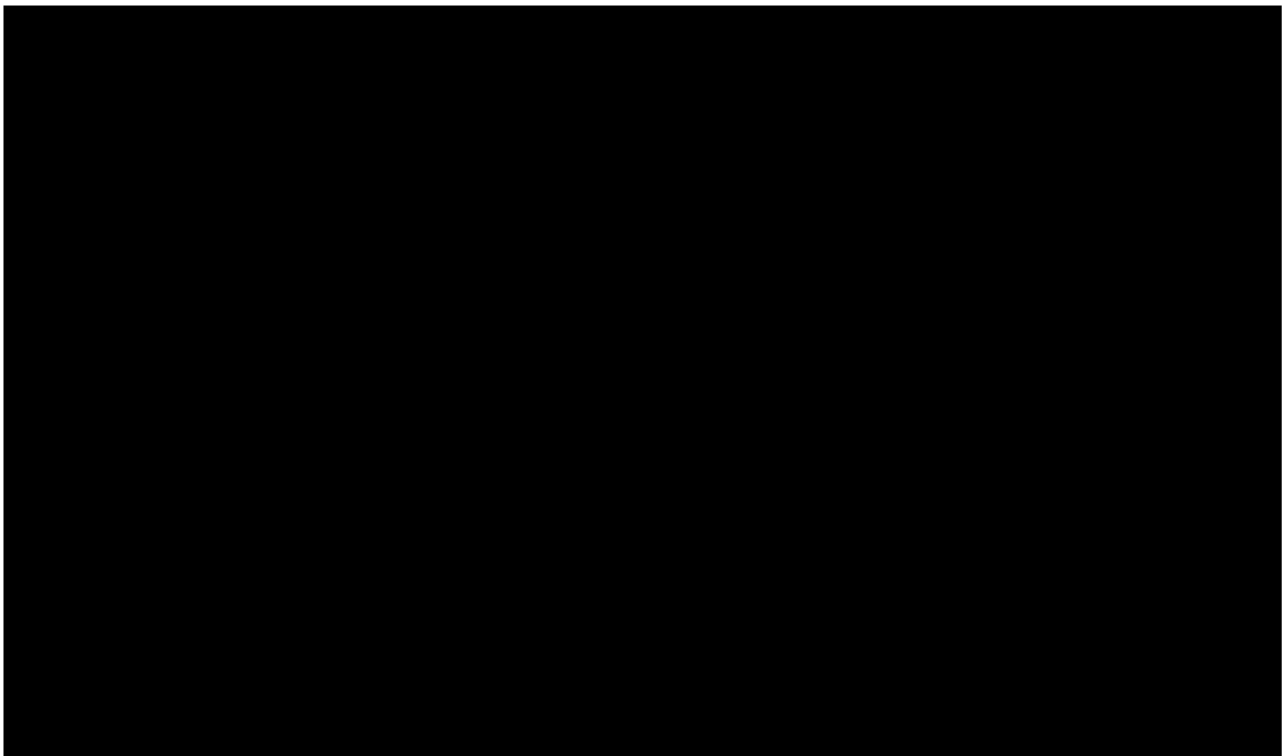
As outlined in Chapter 7 of each of the NSW DNSP's regulatory proposals, the AER's proposed transition approach will not contribute to the achievement of the national electricity objective, is inconsistent with the revenue pricing principles set out in section 7A of the National Electricity Law and the relevant provisions of the National Electricity Rules.

As discussed at the AER Board meeting, while we note that the AER is required to set an allowance for the cost of debt based on a benchmark efficient firm, we nevertheless consider it helpful for the AER to gain an understanding of the current efficient forecast cost of debt across the NSW DNSPs.

Figure 1 below illustrates our current forecast cost of debt across the NSW DNSPs. The following chart compares:

- The benchmark efficient trailing average cost of debt estimated using Reserve Bank of Australia (RBA) data based on the approach set out in the NSW DNSPs' regulatory proposals;
- The weighted average of the NSW DNSP's forecast cost of debt; and
- The forecast cost of debt using the AER's proposed cost of debt transition approach, assuming both a BBB+ credit rating (as outlined in the rate of return guideline) and a BBB credit rating (the rating supported by the NSW DNSPs).

Figure 1: NNSW forecast cost of debt v Trailing Average & AER transition approach



When reviewing Figure 1, it should be noted that:

- The NSW DNSPs' forecast weighted average cost of debt is based on existing debt issuances (issued on a staggered basis over the long term) and our latest forecast of forward rates;
- The trailing average cost of debt is estimated using the approach outlined in the NSW DNSPs' regulatory proposals and our latest forecast of forward rates; and
- The cost of debt using the AER's proposed transition is estimated using RBA estimates of the cost of debt for both BBB+ and BBB Australian corporate entities

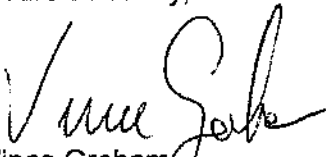
between February and June 2014¹ combined with our latest forecast of forward rates (not converted to an effective maturity of 10 years).

As illustrated in Figure 1 above, the Networks NSW forecast actual debt costs closely track the trailing average cost of debt. However, the AER's proposed approach to setting the cost of debt would significantly under-compensate the NSW DNSP's relative to both the efficient trailing average cost of debt and their actual cost of debt.

We are currently preparing further analysis to demonstrate the financial sustainability and credit rating impacts over the 2014-19 regulatory control period associated with the AER's proposed approach to setting the cost of debt using the transition as outlined in the rate of return guideline. We will provide this analysis to the AER shortly.

If you would like to discuss this matter further please contact Mr Mike Martinson, Group Manager Regulation at Networks NSW on (02) 9249 3120 or Mr Iftekhar Omar, Manager Group Regulatory Affairs at Networks NSW on (02) 9269 2695.

Yours sincerely,

A handwritten signature in black ink, appearing to read 'Vince Graham', written over a horizontal line.

Vince Graham
Chief Executive Officer
Ausgrid, Endeavour Energy and Essential Energy

¹ The AER indicated that it would use this averaging period to set the cost of debt under its transition approach based on correspondence dated 20 March 2014.