14 August 2020

[redacted]
General Manager, Networks Finance and Reporting
Australian Energy Regulatory (AER)
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Dear [redacted]

DRAFT WORKING PAPER: ENERGY NETWORK DEBT DATA

Endeavour Energy appreciates the opportunity to respond to the AER's draft working paper on its review of energy network debt data. This paper examines a simple index of actual debt costs developed by Chairmont, the Energy Infrastructure Credit Spread Index (EICSI), to; assess the reasonableness of the AER's return on debt approach, consider the benchmark term and credit ratings, and the overall approach to calculating the return on debt.

In our response to the draft working paper we provide this brief response highlighting our key concerns and suggestions. For our more detailed position we refer the AER to the ENA's submission to this review, which we fully endorse.

To summarise our position, we consider the industry debt data supports the ongoing use of the current benchmark strategy and cost estimation approach. Networks generally issue debt in line with the AER's current assumption and where they do so the cost of debt is broadly in line with the AER's current estimates. However, we note due to the interaction of the AER's approaches to regulatory inflation and cost of debt, that networks have been consistently undercompensated for the actual (efficient) costs. We refer to our submission on the AER's inflation review on this matter.

Our primary concern is the potential use of network debt data to set the overall return on debt or component parts within the calculation. In line with the ENA's commentary, we do not consider industry debt data can be used to set debt compensation for a number of reasons.

Transparency and replicability of the EICSI

Industry data is used as a reasonableness check of the AER's approach. If its role is expanded to setting the cost of debt it would suitably warrant a higher degree of scrutiny and review. However, due to the commercially sensitive and confidential nature of the data, the data cannot be readily shared or reviewed. This would make it difficult for networks and other stakeholders to review a critical input into AER decision making.

The data would also be difficult to update annually, particularly if discretion and judgment needs to be applied in deriving the EICSI which would form part of a binding Rate of Return Instrument (RORI).

Measurement concerns

Following on from the above, whilst CEG note that debt instruments have been excluded from the EICSI, we do not know which instruments have been excluded and the impacts of this. Further, the EICSI uses a simple average of all instruments issued in any 12-month period. This over-weights short-term instruments (which are refinanced more often) and should be corrected by weighting debt instruments by tenor.

The accuracy of the EICSI would also be improved by weighting instruments by value and properly accounting for the higher bppa cost of fees on short-term debt. The EICSI, if relied upon, may not adequately compensate networks as the observed cost of debt does not capture the costs regulated businesses incur to replicate the cost of debt in the prevailing WACC via hedging.

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It is also worth noting that a number of network businesses were privatised in recent years. These transactions temporarily relied on short term bank debt which we expect will be gradually refinanced in to longer term facilities, which may skew the results both within and between the averaging periods examined in the report.

Impact on network incentives

Setting debt costs based on actual practices would shift the risk of networks debt management strategies to customers. A benchmark approach better balances risk and cost and should be maintained. It should also be noted that networks may still be in the process of transitioning to the benchmark approach and instability or unnecessary change in the regulatory framework may erode investor confidence.

Further, whilst benchmarking techniques can be applied to the cost of debt, equity costs are unobservable. If the AER were to benchmark the cost of debt without considering equity, networks would have a perverse incentive to raise their debt risk premiums. Whilst the WACC would be unchanged (as market value should be independent of capital structure) the EICSI would provide for higher cost of debt compensation.

In addition to the use of industry debt data, we also have concerns with the conclusions drawn from the AER's credit rating analysis. Whilst the historical data is consistent with the benchmark credit rating we do not consider the analysis can be used to assess the impacts of the 2018 RORI. This is because the industry debt data covers up to midway through 2019 and does not meaningfully cover the effects of the 2018 RORI and the network determinations it has (or will be) applied to. It is important that the benchmark credit rating is consistent with the cash flows delivered by the prevailing RORI.

If you have any queries or wish to discuss our submission further please contact [redacted] [redacted] or via email at [redacted]

Yours sincerely

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Deputy Chief Executive Officer