3 September 2021

Mr Warwick Anderson
General Manager, Networks Finance and Reporting
Australian Energy Regulatory (AER)
GPO Box 3131
Canberra ACT 2601

Dear Mr Anderson

DRAFT WORKING OMNIBUS PAPERS: OVERALL RATE OF RETURN, EQUITY AND DEBT

Endeavour Energy appreciates the opportunity to respond to the AER's three draft working papers on the overall rate of return, the return on equity and the return on debt. We note these papers closely follow the term of the rate of return and rate of return and cashflows in a low interest rate environment working papers. Given this, the AER may not have had an opportunity to incorporate a response to key positions raised in our response to those papers. In particular, our feedback on the role of financeability, issues to resolve in the Energy Infrastructure Credit Spread Index (EICSI) and risk-free rate in a low interest rate environment remain relevant.

The key positions and matters discussed in our response can be summarised as follows:

- **Overall rate of return:** this paper provides a useful overview of the AER's preliminary positions across the RORI. It is worth noting that whilst these responses focus on contentious matters we are aligned with the majority of the AER's preliminary positions. We also support the amended assessment criteria which increases the emphasis on the materiality and sustainability of proposed changes.

  On the detailed matters we agree that cross checks should not be used in a deterministic manner. However, we remain of the view that they are a simple test that can help inform whether the overall ROR is robust and supports the underlying assumptions used to derive it. We also support consideration of new evidence to inform the gearing and gamma estimates subject to the assessment criteria above.

- **Cost of debt:** the AER consider the EICSI reveals an outperformance and that the benchmark assumptions should be updated for this. Specifically, using the EICSI to update the benchmark credit rating and/or the corresponding weighted average term to maturity at issuance (WATMI) to update the benchmark term.

  In our response to the term paper we identified issues with the EICSI that require resolution before further reliance could be placed on it. Following this, if there is outperformance that warrants an adjustment it should targeted and maintain the replicability of the benchmark. However, ENA analysis indicates an immaterial level of outperformance and that an appropriately specified, tenor-weighted EICSI supports the AER's existing assumptions.

- **Cost of equity:** the AER remain open to considering a 5 year term of equity and establishing a relationship between the Market Risk Premium (MRP) and risk free rate (RfR). We support the ongoing use of the Sharpe Lintner (SL) CAPM as the foundation model but do not consider there is any evidence to support moving away from a 10 year term for equity.

  There also remains a substantial amount of expert evidence and network positions presented through the Pathways process and in response to the first two working papers that requires further consideration. This includes how dividend growth model (DGM) estimates and cross checks could be used to set a more forward-looking and robust MRP and equity estimate, the negative relationship between the MRP and RfR and whether (and how) to account for this, whether government bond yields remain the best unbiased estimate of the RfR and how the Beta estimate could be improved from reviewing and expanding the existing dataset.

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

51 Huntingwood Drive, Huntingwood, NSW 2148
PO Box 811, Seven Hills, NSW 1730
T: 133 718

endeavourenergy.com.au

ABN 11 247 365 823

If you have any queries or wish to discuss our submission further please contact myself on [redacted] or Patrick Duffy, Manager Regulatory Transformation & Policy at Endeavour Energy on [redacted] or via email at [redacted]

Yours sincerely

Françoise Merit

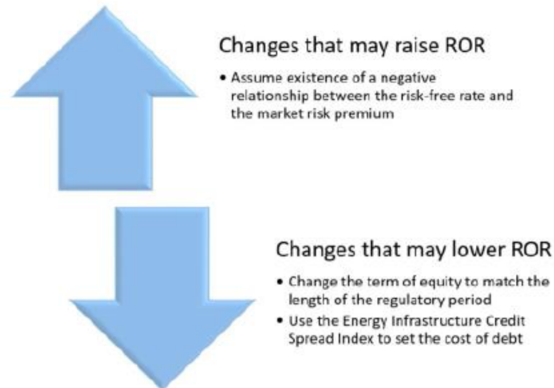
Chief Financial Officer

Appendix A – Endeavour Energy detailed response

Overall paper

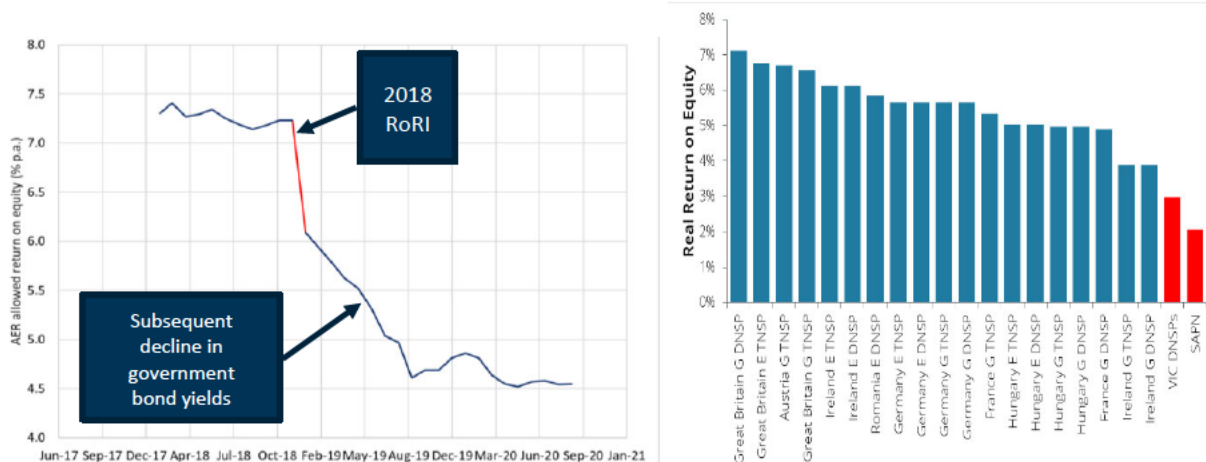
We appreciate the clear and concise listing of RORI positions and issues canvassed and note that we are aligned with the majority of AER positions. Although we question the framing of the outstanding matters in Figure 3 of the paper:

Figure 3 Possible changes that may raise (or lower) the rate of return



This figure suggests changes with both positive and negative impacts on the ROR are being considered. We do not agree that establishing a relationship between the MRP and RfR will increase the ROR relative to the status quo as implied in the above figure.

Instead, this change would benefit customers and investors in reducing volatility in returns by moving away from the 1:1 movement between the RfR and equity risk premium that currently occurs. Since the 2018 RORI, sharp and continued declines in the RfR have resulted in material reductions to the ROR as initially determined. As noted by the AER's consultant Brattle, this has resulted in a regulated return on equity that is amongst the lowest of internationally comparable peers[1].



In the short-to-medium term a market recovery is expected[2]. Under the status-quo approach networks would receive the benefit of 1:1 movements in the return on equity and the RfR. Despite realising the full downside risk of the AER's current approach networks remain supportive of adopting an approach that produces more stable outcomes in the long-term interests of customers.

Relative to the status-quo, establishing a relationship between the MRP and RfR is likely to result in a lower ROR over the term of the 2022 RORI. This distinction may seem trivial, but we consider it noteworthy that the material unresolved matters present a downside risk to networks relative to the 2018 RORI when the 2018 RORI is already delivering unprecedented and internationally low returns.

[1] ENA, AER Public Forum – Draft Working Paper: Equity Omnibus Paper, 11 August 2021, slide 2

[2] RBA, Statement on Monetary Policy – August 2021, 5 August 2021, p. 69

Assessment criteria

We support the AER's proposed assessment criteria including the addition to regard the materiality of any proposed change and the sustainability of new arrangements. These additional considerations suggest that existing precedents and approaches should not be revised unless there is new and compelling evidence or data that supports a material change.

This is appropriate and should prevent relitigating previously settled matters and provide for a balance between improving the RORI in response to new information and providing for regulatory stability. It is for this reason we are particularly concerned with the consideration of a 5 year term of equity and the use of actual network debt data to adjust the cost of debt benchmark. The former is not supported by new evidence and the latter will establish a low precedent for change that will most likely result in incremental updates being made at every RORI review. We discuss these issues in the sections below in more detail.

We also agree that the long-term interests of customers should remain the overarching objective. This objective will best be served by an unbiased estimate of the expected efficient return, consistent with the relevant risks involved in providing regulated network services.

Gearing

The AER's preliminary position is to adjust the gearing ratio to more closely align with updated market data which suggests a 56:44 gearing ratio (when using a 10-year period) compared to the current 60:40 ratio. It is appropriate in our view to update inputs where the available data indicates a material movement has occurred since the last RORI review.

We support having regard to market value estimates of gearing but question whether the threshold for change has been met. Market value gearing will vary with stock price movements meaning mid-cycle impacts may result in the gearing ratio oscillating between RORI reviews. Further, the inclusion of hybrid securities and subordinated debt in the dataset may instead support the current 60:40 assumption. We consider securities with the economic characteristics of debt should be treated consistently across WACC parameters and therefore included in the gearing data.

Once the figures have been updated there will need to be a consideration of whether any resulting update to the gearing ratio meets the AER's assessment criteria and would better promote the long-term interests of customers. As noted above, a change may not be sustainable to the extent the updated figures reflect mid-cycle conditions.

In addition to this, we also question whether the change has a material enough impact on the WACC to warrant it. Our expectation is that a change, particularly a minor one, should not result in a higher or lower WACC per the advice of Partington and Satchell[3]:

> *We consider that small changes in leverage, say plus or minus five percent, are likely to have little appreciable effect on the cost of capital for Australian regulated energy networks and that even outside this range changes in the cost of capital are likely to be small until extreme levels of leverage are reached.*

In the overall ROR paper the AER discusses how changing the gearing assumption may impact other components of the WACC. For instance, the cost of debt credit rating benchmark and equity beta may need to be updated to reflect any change to gearing. We would be interested in understanding the quantum of any impact from changing the gearing assumption in future papers in order to confirm our position.

Gamma

Similar to the above, the AER proposes reviewing the available data and updating its gamma assumption if necessary. Unlike gearing, a preliminary position is not available at this time as the AER is awaiting updated information from the ATO. The AER is also considering whether its assumptions that international investors receive no value from imputation credits requires amendment.

We support further review of ATO net franking credit usage data and maintaining the current assumption for non-resident investors. On the latter, we note that it would be inconsistent with the utilisation approach to consider the market value foreign investors assign to imputation credits. We therefore agree with the AER's preliminary view that foreign investors remain irrelevant to the estimation of gamma.

---

[3] Partington, G., and Satchell, S., Report to the AER: WACC and Leverage, 19 May 2021, p. 6

Use of cross checks

The AER remain of the view that cross checks are limited, complex and cannot be used deterministically. The paper also reiterates several positions from the AEMC's consideration of the TransGrid Financeability participant derogation rule change request, including[4]:

- the importance of regulatory stability;
- FFO/net debt not being a central or deterministic measure of financeability;
- periods of low or negative NPAT forming part of an investment cycle; and
- that networks can and do continue to raise capital and manage capital structures.

The AER then examines a number of measures it considers to be potential cross check measures. Specifically, historical profitability, RAB multiples and investment trends which, in its view, do not indicate any material financeability concerns exist.

We maintain our position from low interest rate paper and refer the AER to our response to that paper given the Overall ROR paper was released only shortly after our response was submitted. To summarise, we agree that measures of financeability should not be used in a deterministic manner to adjust the ROR. Instead, we consider it is good regulatory practice to cross check whether the ROR delivers financial outcomes consistent with the assumptions used to derive it and that it performs reasonably under a range of potential scenarios given it applies for several years.

With this in mind we do not consider the countermeasures networks can take to address credit rating concerns are relevant to the task at hand. Further, the cross checks examined by the AER are not useful in assessing the adequacy of the 2022 RORI because:

- they are backwards looking and therefore do not provide insight as to whether a RORI forecast will perform reasonably moving forward;
- it is misleading to suggest that a RAB multiple should be equal to the book value of a firm (i.e. 1)[5] given this is out of step with theory and observed market outcomes. The market value of a firm will be impacted by a broader range of factors than its book value. For instance, the value of its unregulated activities, reduced transaction costs (such as debt and tax), investment portfolio balancing, accessing intangible assets, etc;
- there are unresolved issues with the AER's profitability reporting that make it a misleading and inaccurate measure. For instance, it blends academic estimates with actual results and includes items not recognised in standard profitability accounting and reporting; and
- none of these measures are a direct reflection of the historic, prevailing and most importantly forecast RORI and are instead driven by a variety of factors.

We therefore recommend further consideration of international benchmarking and financeability cross-checks that are forward looking and which directly test the 2022 RORI under a range of scenarios in future papers. The exercise of judgement is invariably required in developing individual parameter estimates and cross-checks could help inform the AER's assessment of whether the overall ROR satisfies the RORI objective over the term of its application or whether further consideration is required.

Equity

We support the AER's preferred position that the SL CAPM remains the foundational model and that CGS yields are used as a proxy for riskless investment. The focus of the AER's equity paper is on unresolved matters such as the term of equity, updating the Beta comparator dataset, the relationship between the MRP and RfR and whether there is a role for using DGM estimates in informing this relationship and a forward looking MRP.

Forward looking MRP and its relationship with the risk free rate

Currently, the MRP is set based on Historical Excess Returns (HER) using both geometric and arithmetic means and by reference to market practices as obtained from survey data. In the 2018 RORI the AER selected a sampling period of 1988-2017 which produced a HER estimate (arithmetic) of 6.1% which the AER used to set the MRP.

[4] AER, Overall rate of return – Draft working paper, July 2021, pp. 54-57

[5] AER, Overall rate of return – draft working paper, p. 47

If the AER was to continue with this approach the updated sampling period (1988-2021) produces an arithmetic mean HER estimate of 6.5%[6].

However, as part of the 2022 RORI review process to date, the AER has obtained expert advice from both CEPA and Brattle which suggest its current approach does not produce a forward looking MRP and is out-of-step with international regulatory practice[7] [8] [9]:

> *The international regulators that we examined do not rely on an estimate of the MRP that is wholly or even substantially based on the historic average of the realised MRP.*

and

> *the CAPM using a historical MRP relies on backward-looking information, while the Dividend Growth Model (DGM) uses forward-looking information. During periods of changes in financial markets, it becomes important to consider both historical (stable) and forward-looking (contemporaneous) information.*

and

> *We think that it is beneficial to incorporate at least some forward-looking evidence into the cost of equity determination.*

A historical measure reflects the market conditions that occurred over the relevant historical period rather than the forward-looking expectations. Further, the AER's current approach produces a fixed MRP that is constant over time which as a result knowingly over or under compensates investors depending on the circumstances as noted by Dr Lally[10]:

> *Since the MRP estimated by the AER is very stable over time (because high weight is placed on the long-term historical averaging methodology), and the true value is likely to fluctuate much more than this (with high values during unfavourable economic conditions and low values during favourable economic conditions), the MRP is likely to be overestimated during favourable economic conditions and underestimated during unfavourable conditions.*

Based on the advice of Dr Lally, CEPA and Brattle it is clear that the current approach does not produce an unbiased estimate of the MRP and it worth investigating whether a better approach is available. In particular, assigning weight to HER, an estimate of the Total Market Return (TMR) (i.e. Wright Approach) and forward looking DGM should be explored further per the advice of CEPA and Brattle.

Despite this, the AER remain sceptical of DGM and are concerned that it could be upwardly biased. It is important that a reasonable standard of precision is applied in assessing expert views and available information. For instance, the AER continues to rely on geometric mean HER and survey data despite known and material flaws with each.

On the use of geometric means the ENA previously noted during the 2018 RORI[11]:

> *..the Explanatory Statement has material regard to geometric means on the basis of speculation that investors may compute compounded returns in some of the other calculations that they perform (p. 212). Indeed, the influence of geometric means on the final MRP estimate has increased materially relative to the 2013 Guideline.*
>
> *Thus, one set of evidence involves a group of experts, including one of the AER's own experts (Dr Lally), providing a mathematical proof that the arithmetic mean must be adopted – because there is no compounding of returns in the AER's process. The alternative evidence is mere speculation that investors may consider compounded returns for some different purpose.*

On survey data, CEPA notes[12]:

> *There are several limitations to survey data as identified by Bishop, Carlton and Pan (2018):*

---

[6] AER 2018 estimates updated by ENA. Year-to-date figures are used for 2021.

[7] CEPA, Relationship between RFR and MRP, 16 June 2021, p. 5

[8] The Brattle Group, A Review of International Approaches to Regulated Rates of Return, June 2020, p. 35

[9] The Brattle Group, A Review of International Approaches to Regulated Rates of Return, June 2020, p. 59

[10] Lally, M., An appropriate term for the allowed cost of capital, 9 April 2021, Footnote 22, p. 33.

[11] ENA, AER Review of the Rate of Return Guideline – Response to Draft Guideline, 25 September 2018, p. 37

[12] CEPA, Relationship between RFR and MRP, 16 June 2021, p. 15

- *the quality of the question asked;*
- *does it ask whether an estimate of the return on imputation credits has been or should be included;*
- *are the respondents "experts" in assessing MRP, or following a common approach;*
- *are the respondents engaged in litigious activities whereby precedent is often more important than departing from it;*
- *behavioral economists recognize that the concept of "anchoring" is prevalent in decision making, thus responses may reflect this view rather than a view which changes with conditions;*
- *changes in respondent mix in an annual survey can make it difficult to assess whether changes in the MRP are as a result of changes in views and underlying conditions or a change in the respondent set;*
- *extreme views and outliers may impact results if a mean is used.*

Despite these flaws, the AER continues to have regard to both geometric mean and survey data in setting the MRP. Whilst it is the AER's prerogative to exercise its judgment, it is not clear how placing any reliance on this evidence accords with the AER's assessment criteria.

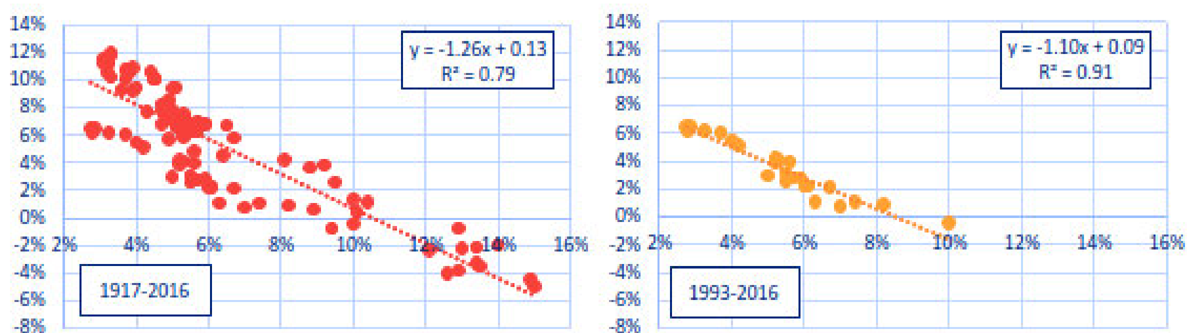
We therefore question whether the reservations of Dr Lally and Partington and Satchell with DGM estimates and the Wright approach are shared more broadly and note that market practitioners and international regulators have managed to make use of these inputs. In our view, the suggestion that Wright and DGM are lower quality inputs relative to survey data and geometric averages in setting the MRP is incompatible with the AER's assessment criteria, theory and market practice.

Ultimately, any estimation method, including the SL CAPM, will be limited and imperfect. These limitations can best be overcome by relying on a broad set of data that is appropriately weighted having regard to the AER's assessment criteria.

With respect to the relationship between the MRP and RfR we are supportive of the AER considering this issue further. The current approach produces a fixed MRP estimate that does not vary at the time of each determination. In practice, this has resulted in significant volatility in the ROR as the return on equity moves 1:1 with movements in the risk free rate.

The evidence suggests there is not a 1:1 relationship between the MRP and RfR but instead a negative correlation. We note CEPA's analysis and findings on this matter[13]:

Figure 5.2: MRP (vertical axis) vs nominal bond yield (horizontal axis). MRP measured as DGM cost of equity estimate (based on outturn data) minus nominal bond yield. DGM assumes long-term growth equal to 40-year average of GDP growth.



Source: CEPA analysis of data sourced from RBA and Thomson Reuters Eikon

and[14]:

> *In the period since 1993, we consider there is a strong and convincing negative relationship between the implied MRP and the RfR……*
>
> *……Our assessment is that (i) there is acceptance that MRP is not stable and (ii) it is possible that there is an inverse relationship between the forward looking MRP and the risk-free rate,*

[13] CEPA, Relationship between RFR and MRP, 16 June 2021, p. 39

[14] CEPA, Relationship between RFR and MRP, 16 June 2021, pp. 6-7

(iii) there is no good evidence that the MRP should be assumed to be independent of the RfR the current assumption of the AER, and (iv) there is no conclusive theoretical basis for an assumption of independence or dependence.

CEPA notes that a fixed MRP, fixed TMR and Hybrid approach all remain open to the AER and that the latter two may produce a better estimate of the forward looking MRP[15]. However, similar to its assessment of the DGM, the AER returns to concerns raised by Partington and Satchell that the Wright approach is implausible in certain circumstances and that there is evidence which supports a neutral, positive or negative MRP/RfR relationship.

We are not suggesting the Wright model be exclusively relied upon and the suggestion of a neutral or positive MRP/RfR relationship is not well supported by evidence or in theory. Indeed, a positive relationship would only serve to increase the volatility in the return on equity which would exacerbate the problem trying to be solved. We consider it would be more constructive in future papers to not question the clear and obvious finding of a negative relationship but to instead consider whether, and how, the available estimation methods can be combined into a single point estimate that best reflects the forward-looking MRP at the time of the RORI. On this task, we note the ENA has developed a calibrated DGM to respond to previous concerns raised with it during the 2018 RORI[16].

Finally, we note that whichever approach is adopted it must be applied consistently. That is to say that if a mathematical relationship is established between the MRP and RfR it would not be appropriate to then only use HER estimates in setting the MRP given HER assumes the MRP is fixed (and vice versa).

RfR

As aforementioned, we support the AER's continued use of CGS yields as a proxy for a riskless asset. However, as noted in our response to the term paper, it is worth considering whether adjustments should be made to account for identifiable differences.

In our response to the rate of return and cashflows in a low interest rate environment paper we noted the convenience yield inherent in government bonds and the impacts of the significant RBA market interventions may necessitate an adjustment. At a minimum these differences highlight that CGS yields are a conservative estimate of the CAPM RfR which is likely downwardly biased as a result. The RBA interventions in particular warrant further consideration in future papers.

Relatedly, we note the CRG have suggested[17] that the MRP remains appropriate and negative real interest rates are instead the problem that should be addressed. The CRG propose an amendment to the CAPM that acts as a floor under the RfR at the rate of expected inflation and note the benefits of this solution. Whilst we do not consider this would address the issues identified with the MRP, negative real interest rates are an issue that should be addressed. We are supportive of the AER giving consideration to this proposal to increase the robustness of the RORI.

With respect to the term of the RfR we support maintaining the current assumption of 10 years as the best estimate of investor expectations for long-lived assets. The Equity paper notes a movement to a 5 year term as an open matter following a re-framing of previous advice from Dr Lally on the AER's regulatory task. We do not consider there is new or compelling evidence since the 2018 RORI that would justify such a material departure from the longstanding use of a 10 year term.

Our position is detailed in our response to the AER term paper which the AER may not have had an opportunity to take into account in preparing the equity omnibus paper. In addition to our response to the term paper we would note CEPA's report cites the practices of a number of independent experts and international regulators. Of those listed in Appendix C of the report 19 of the 22 use a RfR of 10 years or greater[18].

As part of its consideration of the Beta estimate the AER also notes investors in long-lived assets have a long-term investment horizon[19]:

[15] CEPA, Relationship between RFR and MRP, 16 June 2021, p. 7

[16] ENA, AER Public Forum – Draft Working Paper: Equity Omnibus Paper, 11 August 2021, slide 9

[17] CRG, Equity Omnibus Forum presentation, 11 August 2021, slides 13-18

[18] CEPA, Relationship between RFR and MRP, 16 June 2021, pp. 54-56.

[19] AER, Equity Omnibus – Draft working paper, July 2021, p. 43

We set the forward looking rate of return for relatively long-lived assets. Therefore the investment horizon (and risks) needs to be compatible with these assets (which is better met by estimates from the longest estimation period).

The CRG also questions Dr Lally's re-framing of previous arguments and questions the value of revisiting this issue as part of this RORI review. The CRG suggest a high burden of proof would be required to enact such a change[20]:

The Term paper (and the Final position paper on inflation, December 2020) clearly relies heavily on Lally's views. Lally's views are well-documented and have been well-known to the AER and other regulators over many years and regulatory reviews.

…..In such an intellectually contested environment, precedent carries significant weight. This implies the burden of proof lies with the party seeking to break with precedent – even more so when it is the party that has been determined to create that precedent over many years. This is the position in which the AER now finds itself. The Term paper does not respond to this responsibility.

We maintain our view that investors in energy networks have a long-term investment horizon and that the theoretical construct that the end period RAB represents the expected present value of all future cashflows is implausible.

With respect to the averaging period for the RfR the AER propose to shift the nomination window forward one month from 3-7 months prior to a regulatory control period to 4-8 months. We support maintaining flexibility in nominating the averaging period and accept the practical reasons which necessitate a shift in the nomination window.

Beta

The AER's preliminary position is to continue to use an Australian only dataset, potentially adjusted for firms that have been de-listed for a long period of time, and to use the longest estimation window possible for estimating beta.

Whilst investors in long-lived assets have long term expectations it is important that a forward looking estimate is set. This is not to say that the term of equity must match the Beta estimation window, but to question whether the current estimation window results in an essentially fixed estimate of Beta and if this is appropriate. A shorter estimation window does not imply a shorter investment horizon, instead it provides a more contemporary view of the long-term, forward looking risk expectations of investors (provided the comparator firms hold long-lived assets in a similar regulatory environment).

Brattle holds a similar view noting that the AER's current approach is out-of-step with international regulatory practice resulting in beta well below that of international regulators. Brattle suggest the AER's approach would benefit from taking a more forward-looking approach[21].

Fourth, the AER relies on a longer estimation window when it measures equity beta from share price history than other regulators tend to use, and the AER also uses only Australian comparators. Other regulators tend to use a shorter window of 3-5 years, which means the estimates are better able to reflect current conditions. Regulators including ACM, ARERA, FERC, and NZCC incorporate some non-local comparators in their beta estimation.

We therefore recommend that the AER move away from the longest possible estimation window and instead adopt a 10 year estimation window. This period would control for estimation error associated with a smaller window and be more reflective of the current level of systematic risk compared to a longer window.

We note that the Australian dataset contains only 9 firms of which only 3 are currently listed of which one is subject to a takeover bid and another has significant unregulated gas pipeline assets. There has also been significant volatility in the beta estimates for both the live and dead comparators. We therefore support the AER's preliminary position to adjust this dataset for firms that have not been listed for many years (as a minimum) and suggest no weight should be placed on the 'dead' comparators.

With respect to international firms the AER remains of the view that they are not comparable. We maintain our view that they should be given weight and note there are several international regulators

[20] AER CRG, Advice to the AER on the Term of the Rate of Return, 2 July 2021, p. 18

[21] The Brattle Group, A Review of International Approaches to Regulated Rates of Return, June 2020, p. 2

that do so. We would encourage a broader consideration of this option given the significant number of international investors in Australian networks.

In particular, the AER should have regard to the sustainability of its current approach. The current dataset is small with only 3 active comparator firms and it is likely to become more dated, inaccurate and unreliable over time. At some point in time, arguably already, the AER's current approach will become unfunctional. In our view, it is becoming increasingly necessary to have some regard to a broader set of domestic and international comparators.

Debt

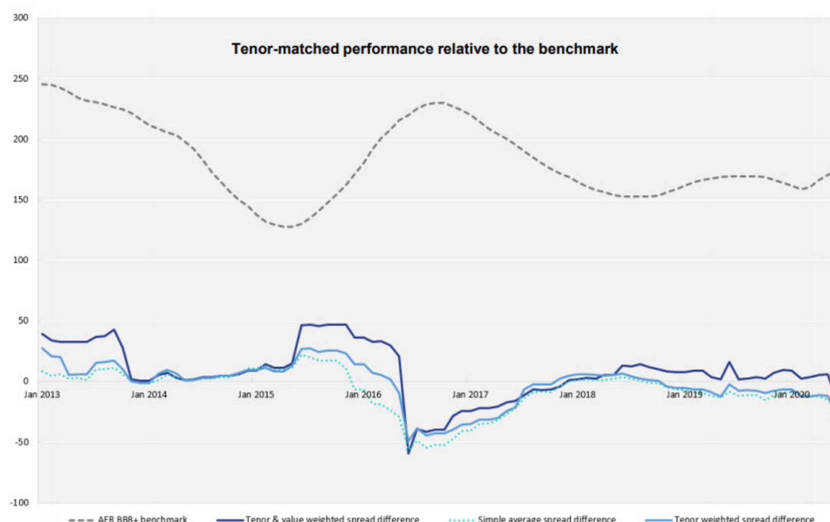
Use of actual network debt data

The AER's preliminary position for the term of debt is to maintain the trailing average approach but use the EICSI to adjust the benchmark credit rating and to match the term of the return to the WATMI. The rationale being that actual network debt data reveals a new efficient practice, which means the current benchmark, if maintained, would over-compensate networks rather than provide a balanced incentive.

In principle we agree that regulatory benchmarks should provide a balanced opportunity to earn rewards or incur penalties and that revealed performance should inform future benchmarks. It is also important to note that networks should be free to depart from a benchmark in practice and should bear the risk of doing so. Where networks clearly and consistently deviate from a benchmark this warrants consideration of whether the benchmark should be amended.

Our concern is that the EICSI does not cover a sufficiently long enough period to establish a case for change and that a number of fundamental issues with the EICSI remain unresolved. We refer to our submission on the term paper for a detailed listing of the issues with the EICSI that require further consideration. In order to place such increased weight on the EICSI the AER would need to address, and clearly codify within the RORI, the methodological issues associated with calculating the EICSI.

With respect to the issues referenced in our previous submission, key matters of note include; the need to value and tenor weight the data, addressing the short averaging period, the consistent treatment (and our recommended inclusion) of subordinated, callable and bank debt and accounting for the impacts of the privatisation of NSW networks on the averaging period. We note analysis from CEG[22] and the ENA[23] indicates that the industry average aligns closely with the AER benchmark once costs are tenor and value weighted.



However, to the extent the AER's additional analysis and adjustments to the EICSI reveal outperformance the source and materiality then needs to be considered. As noted in the debt omnibus paper, the term and credit rating could be two potential sources of any outperformance.

We reiterate observations from Dr Lally and the ENA that it would be inappropriate to adjust the credit rating where the source of outperformance is term related as this would result in a non-viable

[22] ENA, Effective regard to network debt data - response to AER's Energy Network Debt Data Draft Working Paper, August 2020, pp.7-13

[23] ENA, Debt Omnibus Forum presentation, 9 August 2021, slide 6

benchmark debt management approach[24]. If there is outperformance related to the term, there are a number of practical considerations which make an adjustment difficult. As noted by Dr Lally[25]:

- *Altering the term whilst on a trailing average approach would create practical alteration issues in adjusting the transition process or a strategy that is impossible to match*
- *There are concerns around whether the EICSI is a long enough dataset on which to base alterations*

It follows that if the AER considers there is outperformance, this presents a conundrum. Adjusting the credit rating blend is a simple change to implement but likely to result in a non-viable benchmark that violates the NPV=0 principle and creates unhedgeable risk (thereby increasing debt costs in the long-run). Whilst the term is more likely to be the source of outperformance (if any) but difficult and complex to change.

We therefore question whether a change is necessary per the AER's assessment criteria, particularly given the materiality (or lack thereof) of the potential outperformance. We note the ENA and CEG analysis indicates the outperformance is in the order of 2bp when individual instruments are compared to the benchmark at their tenor[26]. This is essentially a confirmation that the AER's current benchmark remains appropriate and no material outperformance exists.

Given the challenges and risks noted above and the lack of confidence in the dataset we do not consider a change is warranted or reasonable at this time. Particularly when the assessment criteria has been expanded to have regard to the materiality and sustainability of any change. Instead, the EICSI could continue to be expanded and improved upon and used as a cross check on the AER's benchmark.

We also note the CRG question the replicability argument and question why networks would object to using the EICSI if it mirrors the existing benchmark[27](noting it may be a more complex approach). In addition to the complexity, we are concerned with establishing a low bar for change. With respect to replicability we consider it is connected to the NPV=0 principle in that a network should be able to achieve a benchmark in order for it to be effective and fair.

It would be unreasonable to give customers the benefits that come from a lower tenor than 10 years (via adjusting the credit rating) whilst continuing to give customers the benefits that come from a 10 year tenor (via a more stable, lower price). We note that the 2018 RORI already corrected for historical outperformance and has demonstrably benefited customers in moving to a 10 year trailing average compared to a more volatile and expensive on-the-day approach. As noted above, when conducting a like-for-like comparison the EICSI does not suggest any material outperformance genuinely and consistently has arisen since the 2018 RORI.

Capex weighting and averaging period

The AER is seeking views on whether the trailing average should be weighted by capex spending. This follows concerns raised around the financeability of large ISP Transmission projects as part of the TransGrid and ElectraNet participant derogation rule change requests. As a distributor our capex profile is likely to be less volatile than that of a transmission network.

We note that in parallel to the 2022 RORI review, the AEMC has commenced a review of the transmission planning and investment framework. Whilst this review will not address RORI matters[28] it is a relevant consideration as to whether capex weighting the trailing average is warranted.

We suggest the AER provide additional details as to how the weighting would work and whether better aligning actual debt issuance profiles is worth increasing the complexity of the current approach.

Finally, the AER proposes the shift the debt averaging period windows forward 1 month, i.e. no later than 5 months before the end of regulatory year rather than 4 months currently. We accept the practical reasons for this change.

[24] ENA, The term of the rate of return – Response to Draft AER Working Paper, 2 July 2021, p. 11

[25] AER, Debt Omnibus – Draft working paper, July 2021, p. 17

[26] ENA, Debt Omnibus Forum presentation, 9 August 2021, slide 6

[27] AER CRG, AER Public Forum – CRG's preliminary response to the AER's Draft Debt Omnibus Paper, 9 August 2021, slide debt presentation , slide 12.

[28] AEMC, Terms of reference – Transmission Planning and Investment Review, 19 August 2021, p. 4