

11 October 2013



Mr Warwick Anderson
General Manager—Network Regulation Branch
Australian Energy Regulator
GPO Box 3131
Canberra ACT 2601

Email to: rateofreturn@aer.gov.au

Dear Warwick

The Energy Users Association of Australia appreciates the opportunity to respond to the AER's Draft Rate of Return Guidelines. The attachment to this letter sets out our response.

We commend the AER for the effort that it has put into the development of the Draft Guideline and Explanatory Statement. While there are many elements that we agree with, particularly in respect of the AER's approach to the determination of the cost of equity, we are concerned that the implementation arrangements for the cost of debt merit more development before their incorporation in guidelines.

We would be pleased to respond to any queries you may have arising from this submission.

Yours sincerely

A handwritten signature in black ink that reads "Phil Barresi". The signature is written in a cursive, flowing style.

Phil Barresi
CHIEF EXECUTIVE OFFICER

1 Cost of Equity

We agree with the approach that the AER intends to take in establishing the cost equity. In particular, we fully endorse the AER's logic that the ability to conduct a balanced review of the cost of equity, that involves consumers, is an important factor in deciding the methodology to apply at each revenue control period. This means preference should be given to approaches that are tractable and transparent. For this reason we support the AER's continue use of the Sharpe-Lintner CAPM. However we have the following main comments to make:

1. We reserve our views on the use of Black CAPM to determine the equity beta, until the AER releases its discussion on that.
2. We strongly encourage the AER to have particular regard to what the NSPs say to their investors, and also to the evidence of the multiples to the RAB at which NSPs' shares are transacted. Such information is likely to be very useful in assessing what firms and their owners actually believe, as opposed to what they argue to the AER.

On this last point, the calculation of the Market Risk Premium and Beta cannot be expected to reflect the many features of NSP regulation that reduce shareholder risk at the expense of risk pass-throughs to users. In this regard we point to cost pass-throughs, contingent projects, re-openers and even the use of NSP-specified averaging periods for the cost of debt as features of the regulation that pass risks through to users, to the benefit of NSP shareholders. These features result in very real reductions in risk, and are reflected in investors' expectations of risks and returns. Again we reiterate the importance to us that the AER takes account of available empirical market and commercial evidence of RAB multiples and NSP investor briefing claims, in determining the appropriate estimate of the cost of equity.

2 Cost of Debt

We support the AER's proposals on the use of a simple trailing average with annual updating during the regulatory control period, and for a single benchmark firm. However, we have concerns about aspects of the implementation arrangements, and we are concerned that there has been limited opportunity for discussion about some of these including the averaging period, rating and tenor. The rest of this section sets out our comments on the various implementation issues.

2.1 The use of the Bloomberg Fair Value Curve (BFVC)

The EURCC's analysis found that the use of BVFC would result in a higher estimate of the cost of debt than the use of actual bond yield data for the cohort of investment grade bonds used in the analysis. We note Smyczynski and Popvic's analysis cited in the Draft Explanatory Statement that suggests that for BBB bonds with a 3 to 7 year term to maturity, the five year BFVC both under and over-estimated the 5 yearly average yield. However their analysis also shows that since the Global Financial Crisis, for most of the time a five year annual BFVC has been above the five year average bond yield.

Chairmont Consulting's (Chairmont Consulting 2012) conclusion in relation to the use of BFVC was that:

“Finally, the rating centric nature of the BFVC construction ... leads to the conclusion that the BFVC results are an inappropriate influence to bring into the specific benchmarking process that AER is undertaking to determine the appropriate Debt Risk Premium.”

Whether or not the use of BFVC provides higher or lower estimates of debt costs (the average yield of all bonds in the cohort) we have other concerns about its use including that its methodology is not replicable and that it is not in the public domain.

Perhaps another service provider, that is able to provide a publicly available and replicable methodology may be able to provide an alternative to the BFVC. In the absence of that, we suggest that the AER reverts to the methodology proposed by the Energy Users Rule Change Committee based on the weighted average yield of bonds with 3 to 7 years to mature.

2.2 Averaging period

The AER proposes that NSPs be allowed to nominate the averaging period window in each year of the regulatory control period during which the rate for that year will be set. This arrangement brings with it the prospect that the rate determined during that window will be higher or lower than the rate determined by the average annual.

We understand that the basis of the AER’s proposal, although not stated, is that the use of an NSP-specified averaging period allows NSPs to reduce the “interest rate risk” that the allowed cost of debt is different to their actual cost of debt. Effectively this enhances the ability of NSPs to “pass-through” its debt costs to users. The resulting reduction in interest rate risk is to the NSPs’ gain. But absent other adjustments, users do not benefit from it. We therefore propose one of two alternatives to deliver a more equitable outcome:

- The AER uses annual averages as proposed by the EURCC instead of NSP-specified averaging periods; or
- The AER’s persists with its proposals that NSPs specify the averaging period, and the resulting diminution in interest rate risk borne by NSPs is taken into account in the determination of the return on equity.

2.3 Tenor

The AER has proposed a seven year tenor for the calculation of the return on debt. We support the AER’s criticism of the analysis by PwC and CEG of NSP debt tenor. We also agree with the AER’s observations on bank debt, and the use of interest rate swaps to effectively shorten tenors of issued bonds. Finally we note the AER’s evidence of the term of debt in 2009, and its observation of the small premium of 10 year debt over 7 year debt. We are convinced by this evidence that 10 year is not the appropriate term for benchmark debt, but not convinced that a 7 year tenor is correct. In particular, based on the evidence in the EURCC’s analysis it would appear that debt issuance since 2009 has more often than not been of shorter tenor than debt issued before 2009. Bank debt, typically of three years or shorter, also seems to have become more common. This would suggest that the appropriate tenor is less than 7 years.

We understand that the AER intends to investigate again the data on bond issues since 2009 and will also examine interest rates swaps and bank debt. We suggest that the tenor for benchmark debt should be guided by the outcome of this study and call on the AER to decide accordingly on this issue in the guidelines.

2.4 Rating

The AER suggests that it will use BBB+ bonds as the benchmark credit rating for bonds to be included in the calculation of the benchmark. However in practice the dataset of suitably dated Australian bonds with a BBB+ rating is small and so in previous determinations, many bonds with a lesser rating were included and we expect that this will continue to be the case in future. Therefore the specification of a BBB+ credit rating does not actually mean that the cost of debt will be determined only through reference to BBB+ bonds.

We have other concerns related to the use of BBB+ credit rating as the reference benchmark rating.

Firstly we note the clear advice by Oakvale Capital and Chairmont Consulting, not to rely on credit ratings in defining the bond cohort, as the AER is proposing to continue doing.

Oakvale Capital in its report to the AER (Oakvale Capital 2011) p.1 suggests

“the industry background of the issuer plays a greater role in determining its yield position relative to other bonds with similar ratings”

Chairmont Consulting (Chairmont Consulting 2012) p.17 made a number of relevant observations in their “key findings”:

- The current benchmarking process is flawed as it works on a principle that predominantly uses ratings to find proxies. If rating is the only thing that qualifies a proxy, then the benchmarking process is inappropriate;
- The industry of the debt issuer proxy is of paramount importance in benchmarking ...;
- The structure of a bond issue, seniority of the debt and other features cannot always be “adjusted away”. Sometimes, these intrinsic features of the debt impact trading spread, sometimes they don’t. It is a judgment call based on the particular structural features;
- The market’s perceptions of the risk of holding bonds are not only driven by credit ratings. Perceptions are formed by assessing all the risks associated with the credit including operational, market, regulatory, macro and micro economic factors and any others that can be perceived. All such risks affect the trading spread. It is also about perception of the future path all these risks might take the bondholder;
- Ratings Agencies, unlike other market participants, do not have the capacity to react in real time to adjust an assessment and are just another market participant;
- Ratings do not encompass all the risks of bond trading and investing;

On page 8 they say:

“The AER regulatory process defines a significant role to the ratings of Credit Rating Agencies (Agencies) in the assessment of a Debt Risk Premium. The conclusion of the Report is that this has led to a circumstance where too much weighting is given to ratings from Agencies in the current benchmarking process. Ratings matter, but they are not the only or most important factor to take into account when considering proxy selections.

Ratings are only one indicator and component of credit risk perception that drives the formulation of potential loss expectations. A credit risk factor is any factor that can affect the operating performance of a debt issuing entity and/or the ability of a debt issuing entity to service and repay debt in a timely fashion.

Ratings agencies are used in the decision making process for assessing creditworthiness of entities. They perform an analytical function. Ultimately though, it is the market place that prices the risks it perceives. Agencies provide only part of the information used in that process and their ratings are not designed to price debt.

It may appear correct to assume that a debt rated as BBB will have a trading spread the same as other BBB debt. However, there is ample evidence that bonds with the same credit rating assigned by Agencies and with the same terms and structural features can trade at different credit spread levels.”

On page 6 they set out three guiding principles for the selection of an appropriate debt proxy:

- “1. Principle 1: The industry and entity specific characteristics of the issuer should be reflected in the industry and entity characteristics of the proxy;*
- 2. Principle 2: Debt structure and seniority and other key features of the debt being benchmarked should be reflected in the key features of the debt proxy; and*
- 3. Principle 3: The proxy bonds chosen should have risks perceived similarly in capital markets to the risks to the debt being benchmarked. The benchmarking process should seek to deliver results consistent with one undertaken by market practitioners in capital markets reflecting their perception of risk relating to the potential proxy bonds”*

Our concern, shared by Chairmont, is that the AER’s approach of relying so heavily on credit rating for the specification of the benchmark is not consistent with Chairmont’s first and third principles. We suggest that as a result of this, the determination of the cost of debt is higher than it should be.

Evidence to support this view can be seen in the AER’s Draft Decision for SP Ausnet (Transmission) released recently. This decision claims a BBB+ benchmark and consistent with the AER’s previous decisions, uses Bloomberg’s BBB Fair Value Curve plus extrapolation to determine the Debt Risk Premium (DRP). In this Draft Decision, the AER determined a DRP for SP Ausnet of 300 basis points.

This seems to be a significant premium to their actual cost of debt, as judged by their two most recent Australian dollar bonds for 10 years and 7 years issued on 7 February and 25 February 2013 respectively. These bonds were priced at swap + 175 bp and swap + 160 bp respectively. Adding 60 basis points to convert from swap to 10 year bond gives a debt risk premium (on a comparable basis to the AER’s definition of DRP) of 235 basis points and 200 basis points respectively. The resulting difference between the AER’s determination and the actual cost of recent issues is therefore 65 to 100 basis points. With an average RAB for the coming three years of \$3bn, and assuming 60% gearing, this difference is therefore worth \$12m to \$18m per year. This translates into allowed revenues of 2.3% to 3.6% per year (based on the AER’s Draft Decision) higher than they would be if the DRP reflected actual outcomes.

We accept that part of the reason for the difference between the AER determination and the actual is explained by the use of the Bloomberg Fair Value Curve and possibly also the method for extrapolating the BFVC to 10 years. However the greater part of the problem is likely to lie with the choice of the BBB rating.

In view of this evidence, and taking account of the advice of Oakvale Capital and Chairmont Consulting, we suggest that the AER considers alternative approaches that reduce the reliance on credit ratings in the determination of the benchmark bond cohort.

One approach adopted by the EURCC and Ofgem is simply to include all investment grade debt in the calculation of the benchmark. This diminishes the reliance on BBB bonds.

A second approach is to restrict the bonds to be included in the calculation of the benchmark, to BBB+ bonds issued by Australian regulated energy network utilities. Our concern with this latter approach is that the resulting dataset may be too small to be useful (and for this reason the AER has used a BBB benchmark dominated by unregulated firms). We encourage the AER to consider which of these approaches may be preferable.

2.5 Weighting and annual updating

On the grounds of simplicity, we support the AER's proposal to use a simple average in the calculation of the rolling average, and also of intra-period annual updating of the cost of debt.

2.6 Transition

The question of whether or not to have a transition is a complex as it depends on other factors including the duration of the rolling average cost of debt that the AER intends to use in its benchmark.

Ultimately we are persuaded by the weight of the AER's mean reversion argument: that it is reasonable for consumers to expect that the excessively high allowances for the return on debt in decisions between 2009 and mid 2012, are followed by allowances that reflect much lower risk free rates and debt risk premia that are currently available. The question then becomes how such transition arrangement should be designed to achieve this.

The AER has proposed a seven year transition period to be applied to each NSP at the start of their next revenue/price control. We do not support this approach. The AER's proposed approach means that the rolling debt calculation will first be applied in 2021 (for NSW distributors, Transend and TransGrid). Other NSPs will only be exposed to the rolling cost of debt for the first time by as late as 2026. This is simply too long to wait. There is no guarantee that a transition period of this length will satisfy the AER's objective of mean reversion (indeed if risk free rates and debt risk premia bounce up again, then the transition arrangements will undermine the objective of mean reversion and the immediate introduction of the rolling average would have been preferable).

Further we note that neither the AER nor the NSPs (nor the EUAA) have argued for the use of a transition on the basis that NSPs' current lending practices need to adjust to the new rolling average approach. Indeed some NSPs, the AER and EUAA have argued to the contrary.

Bringing these arguments together, we suggest a transition period that is not greater than five years, starting on 1 July 2013 for all NSPs except the Victorian distributors (for whom we proposed that the transition period clock should start ticking from 1 January 2014 so that the "transition" corresponds to their regulatory year).

The calculation of the cost of debt for each year during the transition period should be based on the AER's proposed approach, but with the weights in each year set to 1/5th rather than 1/7th. As discussed earlier, we suggest a 5 year tenor, although the use of 7 year tenor is not incompatible with our proposal for a 5 year transition.

References

Chairmont Consulting (2012). Debt Risk Premium Expert Report. A report for the AER.

Oakvale Capital (2011). Report on the cost of debt during the averaging period: the impact of callable bonds.