**Attachment 9-7: Response to AER Draft Decision on Debt Risk Premium**

**9.1 Introduction**

The Debt Risk Premium (‘DRP’) is the margin between the annualised yield on the 10 year commonwealth government bond (proxy for the nominal risk-free rate) and the annualised yield on Australian corporate bonds with a term to maturity of 10 years at the benchmark credit rating level.

Envestra’s preferred method to estimate the DRP is for sole reliance to be placed on Bloomberg’s BBB fair value estimates extrapolated out to the 10 year benchmark term. Envestra considers this will ensure that the benchmark DRP will be based on current data sourced from an independent market participant and will therefore comply with the requirements of rules 74 and 87 of the National Gas Rules (NGR).

In its Draft Decision the AER determined Envestra’s DRP by taking an average of Bloomberg's 10 year, BBB fair estimate curve and the inferred yield on the APT bond and deducting the risk free rate. This produced a DRP of 3.93 percent and the AER considered this to represent the best DRP estimate possible in the circumstances of Envestra.

There are some aspects of the DRP decision that Envestra finds reasonable and accepts. However there are some issues that Envestra disagrees with and proposes an alternative method and/or value to be used in the Final Decision. Accompanying this attachment is an expert report from CEG which Envestra has used to support its position. This report forms part of Envestra’s submission, and the submission should be read in the context of that report.

* 1. **Summary of the AER Draft Decision**

In the Draft Decision the AER has determined that the DRP should be based on an Australian corporate bond issuance with a term to maturity of 10 years and a BBB+ credit rating. Envestra provided to the AER, pursuant to a notice issued by the AER under section 24(2) of the National Gas Law (NGL), certain information regarding its actual cost of debt. The AER stated that it has not based its DRP decision on the actual cost of debt data provided by Envestra, and as such, it has maintained the incentive to achieve efficiencies in its cost of capital by using a benchmark DRP.

To determine the DRP the AER has used the APT bond maturing in 2020[[1]](#footnote-1)) and the Bloomberg BBB 7 year fair value yield estimates, extrapolated to the benchmark 10 year term, to form its views on the DRP. The reason for extrapolating the Bloomberg estimates is that they only publish BBB fair value estimates to a term of 7 years, and the AER assumes a 10 year tenor for the purposes of setting the DRP.

The AER considered that in lieu of Bloomberg publishing a 10 year BBB rated fair value estimate, the spread on Bloomberg's AAA rated estimates from 7 to 10 years should be added to Bloomberg’s 7 year, BBB rated fair value curve. The AER considers that the most reasonable extrapolation approach is to add the spread on Bloomberg's AAA rated estimates from 7 to 10 years — as averaged over the last 20 trading days when these estimates were available, ending 22 June 2010 — to the most recent estimates of Bloomberg’s 7 year, BBB rated fair value curve.

In addition, the AER has departed from previous practice of placing sole reliance on the Bloomberg fair value yield estimate for the following reasons:

* there is some evidence to suggest that the behaviour of the Bloomberg curve since the onset of the GFC is somewhat counter intuitive, including that the extrapolated 10 year DRP derived from Bloomberg currently observed being at an all time high;
* the characteristics of the APT bond closely match those of the benchmark corporate bond set by the AER, namely BBB rated and approximately 10 year maturity. As this bond has a lower credit rating than the BBB+ benchmark, its use would be expected to result in a DRP that overstates the benchmark cost of debt. The nature of the underlying risk and markets in which the APA Group operates resemble those of the benchmark gas pipeline service provider. To the extent that credit ratings are an imperfect indicator of default risk, the APT bond is suitable for deriving a DRP that reflects the risks involved in providing reference services;
* a recently issued A- rated, 10 year bond by Stockland displays yields that are closer to the APT bond, and significantly below the extrapolated Bloomberg 10 year estimates. This gives further support for relying on the APT bond over Bloomberg; and
* a further 10 year BBB+ rated DBCT bond has yields that are higher than Bloomberg’s BBB fair values, however the AER has discounted this observation for the purposes of comparison given previous issues with its owner and credit wrapper.

Given the above the AER considered it prudent to adopt an approach where it did not place complete reliance on either Bloomberg or the APT bond. Accordingly the AER has set the DRP as an average of the spreads of the extrapolated Bloomberg 10 year, BBB fair value estimate and of the APT bond maturing in 2020. Based on the 5.68 percent risk free rate used in the Draft Decision, the AER determined a DRP of 3.93 percent. The AER considers that prevailing conditions have been reflected in the use of data on the APT bond and Bloomberg fair value estimates over the indicative averaging period used for this decision. This data will be updated to reflect prevailing market conditions at the time of the final decision

* 1. **Envestra Response**
		+ 1. **Benchmark for Setting the DRP**

Envestra agrees with, and accepts, the AERs decision to estimate the DRP by using the benchmark of an Australian corporate bond with a term to maturity of 10 years and a BBB+ credit rating.

* + - 1. **Methodology to extrapolate the 7 year BBB Bloomberg fair value yield estimate to the 10 year benchmark**

Envestra accepts the AERs methodology for extrapolating the Bloomberg 7 year BBB fair value curve to the 10 year benchmark. That is, the spread on Bloomberg's AAA rated estimates from 7 to 10 years (as averaged over the last 20 trading days when these estimates were available) is to be added to the most recent estimates of Bloomberg’s 7 year, BBB rated fair value curve.

* + - 1. **Actual Cost of Debt Information**

Envestra agrees with the AER that a regulated entities’ actual debt financing costs, structures and risk management practices are not relevant, and should not be used by the AER in its task of determining the benchmark DRP in accordance with the NGR.

* + - 1. **Stockland A- bond**

Stockland is an ASX listed property owner and developer. It has interests in commercial, residential and retirement living property throughout Australia. Its operating characteristics and credit rating differ substantially from the benchmark regulated energy distribution business. The observations made by the AER in relation to the Stockland A- bond are not relevant in determining the DRP in accordance with the NGR.

* + - 1. **Reliance on the APT bond**

Envestra does not agree with the AER using a 50 percent weighting on the APT bond in determining the DRP. It is unreasonable for the AER to place such significant weight on a single observation as it infers that the entire RAB and capital expenditure debt funding requirement can be priced at that level, which is simply unachievable. CEG comment on this issue in their report titled *WACC Estimation*:

*This methodology places extreme weight on bonds issued by two issuers above the guidance provided by the wider population of 105 bonds and 49 issuers. It relies further upon the exclusion of the relevance of yields on bonds issued by DBCT. In my opinion, neither basis to the AER’s conclusion can be reasonably sustained, and the best estimate of the debt premium is the Bloomberg BBB fair value curve, extrapolated forward to 10 years*.(page 2)

The fact that the tenor and pricing for a BBB energy infrastructure business has not been replicated in the Australian bond market since the APT transaction issue indicates that the yield paid on the APT bond is not representative of market pricing. In support of this observation is:

* the AERs Draft Decision analysis where it has been stated that the Stockland A- rated 10 year bond displays yields that are close to the APT bond yield, which indicates that the APT bond has been mis-priced[[2]](#footnote-2);
* CEGs analysis that shows 75% of the bonds with greater than 5 years to maturity have a higher spread to CGS than the APT bond; and
* CEGs view is that the Bloomberg fair value curve is a better fit to the data than the APT fair value curve for infrastructure issuers with ratings of between BBB and A-.

The AERs low reliance, or exclusion, of the DBCT 10 year BBB+ rated infrastructure bond from its DRP weighting process is not well justified[[3]](#footnote-3) and increases the subjectivity and potential bias in the DRP. In removing bonds from the sample that the AER perceives to be trading with high default risk[[4]](#footnote-4), such as the DCBT bond, then the AER is artificially downwardly biasing its estimate of the DRP. Corporate bond defaults do occur and must be compensated for in the DRP. If reliance is placed on the APT bond then equal weight must be applied to the DCBT bond for the purposes of determining the DRP.

For the purposes of setting the DRP in the Final Decision Envestra is of the view that it is appropriate to apply zero weight to the APT bond yield[[5]](#footnote-5).

* + - 1. **Bloomberg Fair Value Purportedly Counter-Intuitive**

The AER has the view that the Bloomberg fair value curve is somewhat counter intuitive, including the extrapolated 10 year DRP derived from Bloomberg currently being at an all time high. Since the onset of the GFC there have been a number of changes in investor’s views about the appropriate level of compensation for risk, regulatory changes that have and/or will increase the cost of capital (e.g. Basel III) and the supply and demand for capital. All of these factors will increase the cost of capital into the future. These issues are discussed in depth in the McKinsey Global Institute publication *Farewell to cheap capital? The implications of long-term shifts in global investment and saving*, December 2010. Bond investors take a forward looking view about risks and required rates of return and these appear to have been reflected in the Bloomberg fair value yield curves, which do not seem counter-intuitive at all.

* + - 1. **Reliance on Bloomberg Fair Value**

Bloomberg provides independent and ‘fair value’ estimates of the yields on various corporate bonds. These yield/cost of debt estimates are not the lowest, or the highest, cost of debt attainable. But rather these are estimates of what it would cost to issue, and/or trade, a corporate bond with sufficient volume, liquidity and marketability in the domestic market place at the stated credit rating level. The AER’s view that placing sole reliance on Bloomberg estimates would result on a rate of return that is excessive is based on an incorrect finding that the Bloomberg estimates do not reflect prevailing conditions and that financial market conditions have “substantially improved” since the GFC.[[6]](#footnote-6)

For the reasons set out above, Envestra’s view is that Bloomberg provides independent and ‘fair value’ yield estimates and they are an appropriate basis for determining the benchmark cost of debt and DRP in accordance with the requirements of the NGR and NGL. This is particularly the case given concerns over the relevance of the APT bond issuance for setting the DRP.

Therefore, using the nominated 10 day risk free rate averaging period ending 10 March 2011, the DRP to be used in Envestra’s in the Final Decision is 4.67%. Details of the calculations are set out below:

|  |  |  |  |
| --- | --- | --- | --- |
| **Date** | **Risk free Rate****(10 Year CGS annualised yield)**  | **Bloomberg BBB 10 Year fair value yield (annualised)**  | **Debt Risk Premium** |
| 25-February-2011 | 5.60% | 10.29 % | 4.69 % |
| 28-February-2011 | 5.56% | 10.24 % | 4.68 % |
| 01-March-2011 | 5.59% | 10.27 % | 4.68 % |
| 02-March-2011 | 5.55% | 10.22 % | 4.67 % |
| 03-March-2011 | 5.60% | 10.30 % | 4.71 % |
| 04-March-2011 | 5.65% | 10.30 % | 4.65 % |
| 07-March-2011 | 5.59% | 10.24 % | 4.65 % |
| 08-March-2011 | 5.62% | 10.27 % | 4.65 % |
| 09-March-2011 | 5.63% | 10.28 % | 4.65 % |
| 10-March-2011 | 5.57% | 10.22 % | 4.65 % |
| **10 Day Average** | **5.60%** | **10.27%** | **4.67%** |

1. The APT bond is rated BBB and will have a remaining term to maturity of 9 years when the Final Decision is implemented in July 2011. This credit rating and term to maturity is not consistent with the 10 year benchmark. [↑](#footnote-ref-1)
2. *Prima facie* the APT bond should have a substantially higher yield than the A- Stockland bond given its two notch higher credit rating differential. [↑](#footnote-ref-2)
3. In removing bonds from the sample with what is perceived to be a high default risk, such as the DCBT bonds, then the AER is artificially downwardly biasing its estimate of the DRP. Corporate bond defaults occur and must be compensated for in the DRP. [↑](#footnote-ref-3)
4. This includes some other type of negative credit event from the investors perspective [↑](#footnote-ref-4)
5. Envestra notes that the use of the APT bond in setting the DRP for Jemena Electricity Networks in the Victorian Electricity Price Determination 2011-2015 is the subject of an application for review before the Australian Competition Tribunal. The AER has noted this and indicates it will consider the outcome of the merits review and the implications for the DRP as appropriate (page 94, Draft Decision (SA). [↑](#footnote-ref-5)
6. Draft Decision (SA) page 94. [↑](#footnote-ref-6)