

Submission in response to the Mountain Report on DRP

Prepared jointly by the
Victorian Electricity Distribution Businesses

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**UNITED ENERGY
Distribution**

Executive Summary

On 19 August 2010, the Energy Users Association of Australia (**EUAA**) submitted a report from Mr Bruce Mountain of Carbon Market Economics to the Australian Energy Regulator (**AER**) critiquing the AER's approach to determining the debt risk premium (**DRP**) in its draft decision (**Mountain Report**).¹

The Joint Victorian DNSPs (**Joint DBs**) have concerns with the conclusions reached in the Mountain Report and submit that the AER should not place weight on the opinions expressed in the report when making its final determinations.²

In particular, the Joint DBs submit that the Mountain Report:

- proposes a departure from the National Electricity Rules (**NER**), which is unjustified
- proposes a departure from the AER's Statement of Regulatory Intent (**SORI**), which Mr Mountain has not justified in the circumstances
- provides flawed analysis to support an alternative method for estimating the **DRP**, which leads the Mountain Report to conclude that the AER draft decision allowed a **DRP** that was too high
- incorrectly suggests that the **DRP** determined in the draft decision is inconsistent with regulatory precedent.

Each of these points is explained in more detail below.

The Joint DBs also submit an expert opinion letter from PricewaterhouseCoopers that analyses the Mountain Report (the **PwC opinion**).³ This opinion was prepared in accordance with the Federal Court guidelines for expert witnesses.

Furthermore, the opinions expressed in the Mountain Report are not supported by a statement of the author's credentials or expertise. It is not clear from the report that Mr Mountain is an expert in relation to the matters upon which he is expressing an opinion.⁴ Accordingly, the AER should not regard the report as being an expert opinion and should not place weight on it.

¹ Mountain B, *Analysis of the Australian Energy Regulator's Assessment of the Debt Risk Premium in its Draft Decision on Price Controls for the Period 2010/11 to 2015/16 for the Victorian Electricity Distributors*, 13 August 2010.

AER, *Draft Decision – Victorian electricity distribution network service providers: Distribution determination 2011–2015*, June 2010 (**AER draft decision**).

² To avoid doubt, the Joint DBs are: Jemena Electricity Networks (Vic) Ltd (**JEN**), CitiPower Pty (**CitiPower**), Powercor Australia Limited (**Powercor**), SPI Electricity Pty Ltd (**SPAusnet**), and United Energy Distribution Pty Ltd (**UED**).

³ PwC, *Review of the Debt Risk Premium in the Mountain Report*, 22 September 2010.

⁴ As an engineer, Mr Mountain has expertise in the benchmarking of operating and capital expenditure for electricity distributors. However, it is not clear whether he has expertise in relation to the matters, of a financial and legal interpretation nature, in the Mountain Report.

Contents

EXECUTIVE SUMMARY	1
CONTENTS	2
1 DEPARTURE FROM THE NER	3
1.1 The Mountain Report departs from the NER.....	3
1.2 The relationship between the NEO and the NER.....	5
2 DEPARTURE FROM THE SORI.....	7
3 ANALYSIS OF THE DEBT RISK PREMIUM (DRP)	8
3.1 Observed and actual costs of debt.....	8
3.2 Swap rates and the cost of debt to DNSPs	9
3.3 Definition of DRP	10
3.4 Averaging period	10
3.5 Yield estimates measured over different periods	11
3.6 DRP for APT Pipelines bond	12
4 REGULATORY PRECEDENT	13
4.1 Australian precedents.....	13
4.2 Ofgem precedent.....	13
APPENDIX A—PWC OPINION LETTER.....	14

1 Departure from the NER

Mr Mountain proposes that the AER should depart from its current approach to determining the DRP and adopt an alternative approach based on observed financing arrangements of individual DNSPs. However this alternative approach is inconsistent with the NER. Accordingly, the AER should not adopt this approach in its final determinations.

While the AER has discretion under clause 6.12.3 of the NER to reject a value for the DRP in a building block proposal and substitute an alternative value, the AER may only do so to the extent necessary to ensure consistency with the NER.⁵

The Joint DBs submit that the AER should determine the DRP by reference to an appropriate cost of debt benchmark: namely, the cost of debt for a benchmark BBB+ rated 10 year Australian corporate bond (the **current approach**). This benchmark is consistent with the NER and the SORI and with the approaches taken in the AER's recent electricity decisions and in the original and revised regulatory proposals of each of the Joint DBs.⁶

In contrast, Mr Mountain proposes that the AER should calculate the DRP by reference to the actual cost of debt for DNSPs rather than by reference to a benchmark (the **alternative approach**).

The Joint DBs submit that the alternative approach is inconsistent with the requirements of the NER for the following reasons:

- this approach departs from the NER
- this departure is not supported by the National Electricity Objective (**NEO**).

These reasons are discussed below.

1.1 *The Mountain Report departs from the NER*

Clause 6.5.2(e) of the NER defines the DRP to be used in the weighted average cost of capital formula as follows:

The debt risk premium for a regulatory control period is the premium determined for that regulatory control period by the AER as the margin between the annualised nominal risk free rate and the observed annualised Australian benchmark corporate bond rate for corporate bonds which have a maturity equal to that used to derive the nominal risk free rate and a credit rating from a recognised credit rating agency.

The explanatory materials to chapters 6 and 6A of the NER make clear that the return on capital for DNSPs and TNSPs under the rules is intended to reflect the costs faced by a *benchmark* entity. This benchmark offers incentives for the DNSPs to reduce their costs of capital. For instance, the explanatory materials to chapter 6A note:⁷

the allowed rate of return on assets will be based on a benchmark, which will encourage TNSPs to reduce their weighted average cost of capital (WACC) since they will be entitled to retain the difference within the regulatory period.

⁵ NER, clause 6.12.3(f).

⁶ For instance, see: JEN, *Revised Regulatory Proposal*, 20 July 2010, pp. 226–240; CitiPower, *Revised Regulatory Proposal: 2011 to 2015*, 21 July 2010, pp. 340–348; Powercor, *Revised Regulatory Proposal: 2011 to 2015*, 21 July 2010, pp. 331–339; SPAusnet, *Electricity Distribution Price Review: 2011-2015: Revised Regulatory Proposal*, July 2010, pp. 308–323; UED, *Revised Regulatory Proposal for Distribution Prices and Services: January 2011 – December 2015*, July 2010, pp. 185–195.

⁷ AEMC, *Draft Rule Determination: Draft National Electricity Amendment (Economic Regulation of Transmission Services) Rule 2006*, July 2006, p. 10.

The AER noted in its review of WACC parameters that the NER requires it to have regard to the benchmark service provider in determining each component of the return on capital.⁸ The AER also noted that this benchmark approach is consistent with good regulatory practice:⁹

It is common regulatory practice for regulators to use a benchmark approach rather than a business specific approach in estimating the WACC parameters, as this:

- is consistent with the general approach of incentive regulation (a view adopted by other regulators and generally accepted by the businesses);
- means that customers are less likely to bear the cost associated with inefficient decisions (e.g. financing structures), and
- improves the comparability of regulatory decisions.

Mr Mountain proposes an alternative approach that would involve the AER taking into account “wider evidence of debt margins in the capital markets that the distributors actually participate in”, including:

- the market for bank debt in Australia
- rates on international bonds issued by Australian network service providers
- term sheets of recently issued Australian bonds, whether they be exchange-traded or traded through brokers or other intermediaries.

Using these sources of information in the way contemplated by Mr Mountain is inconsistent with the requirements of the NER. Although in some cases such information may be used as a “cross-check” on estimates of the benchmark corporate bond rate, the AER should not use this information to directly estimate the cost of debt under the NER.

As Mr Mountain acknowledges, bank debt is not a “bond” and is not rated by credit rating agencies and therefore cannot be used to calculate the DRP under clause 6.5.2(e) of the NER.¹⁰

Further, a degree of caution is warranted when setting the DRP by reference to internationally issued bonds because clause 6.5.2(e) requires estimation of an *Australian* benchmark corporate bond rate. In previous submissions, the Joint DBs suggested that the AER consider bonds issued by Australian corporate entities in the US market.¹¹ But, in any case, although the AER may consider bonds issued by Australian entities overseas when determining an appropriate cost of debt, the AER should use such information judiciously and appropriately.

Finally, the AER should also interpret with caution information contained in term sheets. A direct application of the yield formulae and results contained in term sheets would be inconsistent with the NER, since term sheets:

- only provide information on individual bonds of various maturities, and
- do not provide information on the benchmark corporate bond rate for the specific rating and at the particular maturity set out in the SORI.

⁸ AER, *Electricity transmission and distribution network service providers: Review of the weighted average cost of capital (WACC) parameters – Final Decision*, May 2009, p. 101.

⁹ Ibid.

¹⁰ Mountain Report, p. 17.

¹¹ See, for example, CEG, *Estimating the cost of 10 year BBB+ debt during the period 17 November to 5 December 2008*, September 2009.

In some cases, term sheets may misrepresent *actual* corporate bond rates, since these documents may also record other types of debt (such as bank debt). Differences between interest costs, margins and upfront fees may not clearly represent some of these other types of debt.¹²

Whilst the sources of information referred to by Mr Mountain may be relevant to, or may inform the determination of, the cost of debt under the NER, the information must be used in a manner that is appropriate. As the sources of information referred to in the Mountain Report do not actually measure the cost of debt as required under the NER, they should not be directly determinative of the cost of debt to be applied in calculating the return on capital.

Mr Mountain acknowledges that the alternative approach “may result in outcomes that could deviate from the requirements of 6.5.2(e)”.¹³ The Joint DBs consider that the alternative approach is inconsistent with the requirements of the NER and therefore submit that the AER should not adopt it when making its final determinations.

1.2 The relationship between the NEO and the NER

Mr Mountain suggests that despite the inconsistency with the NER, his alternative approach should be preferred, in light of the over-arching requirements of the NEO. However, Mr Mountain does not explain:

- how his approach would promote the NEO, nor
- why this approach should over-ride the inconsistency with the NER.

Section 7 of the National Electricity Law sets out the NEO as follows:

The objective of this Law is to promote efficient investment in, and efficient operation and use of, electricity services for the long term interest of consumers of electricity with respect to—

- (a) price, quality, safety, reliability and security of supply of electricity; and
- (b) the reliability, safety and security of the national electricity system.

As noted above, the requirement in the NER for use of benchmark corporate bond rates is intended to promote efficient investment in and use of electricity services. The use of benchmark rates:

- provides DNSPs with an incentive to lower their cost of capital, since they will benefit from any reduction in this cost within the next regulatory period
- benefits consumers, since the cost of inefficient financing structures will not be reflected in the allowed cost of debt.

Thus, the use of benchmark corporate bond rates is entirely consistent with the NEO.

The AER has previously said that it sees no inconsistency between the NEO and any of the NER relating to the rate of return:¹⁴

The NER requirements in the context of the AER’s WACC review are set out in cls. 6.5.2, 6.5.4, 6A.6.2 and 6A.6.4. The AER does not consider that there are any requirements in these sections of the NER that cannot be reconciled with the NEO.

¹² For instance, the Mountain Report identifies a number of debt issues that are primarily bank debt. As PwC point out, the actual cost of debt for bank debt must also include the upfront establishment fee. See: PwC, *Review of the Debt Risk Premium in the Mountain Report*, 22 September 2010, p. 2.

¹³ Mountain Report, p. 15.

¹⁴ AER, *Electricity transmission and distribution network service providers: Review of the weighted average cost of capital (WACC) parameters – Final Decision*, May 2009, p. 55.

Accordingly, the AER should not prefer an approach that is inconsistent with the NER, such as the alternative approach, on the grounds that it promotes the NEO. The relevant NER provisions are intended to produce a rate of return that reflects the costs of a benchmark DNSP, rather than the DNSPs individually. This is a key part of the incentive framework built into the NER which is aimed at promoting the NEO.

2 Departure from the SORI

Even if the alternative approach in the Mountain Report satisfies the requirements of the NER, the AER would need persuasive evidence to justify a departure from the approach to the DRP set out in the SORI.¹⁵ Mr Mountain has not justified such a departure.

The SORI states that the AER will measure the Australian benchmark corporate bond rate by reference to bonds with a credit rating of BBB+.¹⁶ The SORI also states that the maturity used to measure the risk free rate (and therefore the DRP) is 10 years.

Mr Mountain relies on a sample of bonds issued by Victorian distributors which have neither the credit rating nor the maturity set out in the SORI. These include:

- bonds with terms of between 2 and 5.5 years, and none with a maturity close to 10 years
- bonds with credit ratings above BBB+ (such as those issued by SPAusnet).¹⁷

Although these alternative sources of information may help inform the determination of the benchmark corporate bond rate for 10-year BBB+ rated corporate bonds, without more analysis, they should not be determinative in themselves. This is entirely consistent with the Joint DBs revised regulatory proposals, which propose using similar information sources to:¹⁸

- cross-check the reasonableness of (a) the CBASpectrum and Bloomberg fair value curves and (b) DRP estimates for 10 year BBB+ rated Australian corporate bonds
- identify (or not) outliers in a sample of BBB+ rated fix rate bonds.

However by relying solely on his sample of bonds to estimate the DRP, Mr Mountain proposes a departure from the AER's position in the SORI, which is not supported by any evidence.

Mr Mountain does not suggest that the BBB+ credit rating is inappropriate, nor does he query the 10-year maturity set for the risk-free rate. Rather, he presents evidence that the *actual* cost of debt to particular DNSPs is in some cases below that proposed by the AER in its draft decision. However, this evidence is largely irrelevant to the determination of the cost of debt for a *benchmark* DNSP, as required under the NER.

¹⁵ NER, clause 6.5.4 (g).

¹⁶ AER, *Electricity transmission and distribution network service providers: Review of the weighted average cost of capital (WACC) parameters – Final Decision*, May 2009.

¹⁷ See, for instance, PwC, *Review of the Debt Risk Premium in the Mountain Report*, 22 September 2010, pp. 7–9.

¹⁸ For instance, see: JEN, *Revised Regulatory Proposal*, 20 July 2010, pp. 226–240; CitiPower, *Revised Regulatory Proposal: 2011 to 2015*, 21 July 2010, pp. 340–348; Powercor, *Revised Regulatory Proposal: 2011 to 2015*, 21 July 2010, pp. 331–339; SPAusnet, *Electricity Distribution Price Review: 2011-2015: Revised Regulatory Proposal*, July 2010, pp. 308–323; UED, *Revised Regulatory Proposal for Distribution Prices and Services: January 2011 – December 2015*, July 2010, pp. 185–195.

3 Analysis of the debt risk premium (DRP)

Mr Mountain relies on analysis of the observed cost of debt and DRP for particular DNSPs (**the analysis**) to support his conclusion that the DRP determined in the AER draft decision is too high. However, this analysis is flawed. This analysis is also selective in terms of the time at which various parameters are measured, the debt issues used, and the manner in which it is conducted.¹⁹

This view is supported by PwC, which concludes:²⁰

In our view, Mountain's results provide misleading information about the debt risk premium that is required by the National Electricity Rules and the AER's Statement of Regulatory Intent. We also consider that Mountain's use of the term 'debt risk premium' is inconsistent with its common and accepted usage.

Accordingly, the Joint DBs submit that the AER should not rely on the analysis when making its final determinations.

Mr Mountain calculates the cost of debt using the 90-day bank bill swap rate applying at the time of various debt transactions (or issues) involving particular distribution DNSPs and their parent companies, including SPAusnet, DUET and Spark Infrastructure. The timing of these debt issues ranges from November 2008 to February 2010, a time of unprecedented volatility in financial markets.²¹ The DRP is then derived for all issues by subtracting the risk-free rate measured at a single point in time—that is, the risk-free rate adopted by the AER in its recent draft decision.²²

This analysis is flawed because it:

- confuses 'observed' costs of debt with 'actual' costs of debt
- uses the 90-day bank bill swap rate plus a margin as a proxy for the cost of debt to DNSPs, even though this swap rate reflects the risks between banks not the risks of a benchmark DNSP
- incorrectly defines the DRP for debt issues with various maturities in conjunction with a 10 year risk-free rate
- uses an incorrect averaging period for each of the Joint DBs
- uses yield estimates measured over different periods
- incorrectly calculates the DRP for the APT Pipelines bond.

Each point is discussed in more detail below.

3.1 *Observed and actual costs of debt*

Mr Mountain refers to the 'observed' costs of debt for particular DNSPs, and equates these costs with the *actual* costs of debt issued by DNSPs, where the debt is in the form of bank loans or instruments on international bond markets.²³ He also distinguishes between an *observed* annualised Australian benchmark corporate bond rate and an *inferred* (or calculated) rate.²⁴ However, in both cases, Mr Mountain appears to confuse the term 'observed' costs of debt, as required by the NER, with actual (or directly observed) costs of debt.

¹⁹ In particular, there were numerous other debt issues over the 2008 to 2010 period that were not presented in the Mountain Report. This is the period during which the debt shown in Table 1 of the Mountain Report was issued.

²⁰ PwC, *Review of the Debt Risk Premium in the Mountain Report*, 22 September 2010, p. 3.

²¹ For instance, see: PwC, *Victorian Distribution Businesses: Methodology to Estimate the Debt Risk Premium*, November 2009, pp. 15–16.

²² Mountain Report, pp. 5–6.

²³ See, for example, Mountain Report, p. 4.

²⁴ Mountain Report, p. 4.

Mr Mountain gives a strict literal meaning to the term 'observed', suggesting an interest rate or yield which is actually read. However the AER has previously offered a broader interpretation, arguing that the term 'observed' also "captures a process of analysis or estimation as required".²⁵

In its final decision on the Victorian AMI charges applications,²⁶ the AER posited that neither the 'benchmark bond rate', nor annualised bond rates for Australian corporate bonds with 10 year maturities and BBB+ credit ratings, were actually directly observable in the market. The AER then stated that 'observed' should not be construed as meaning directly observed. This interpretation is entirely consistent with the AER draft decision, which sought to 'observe'—via a process of analysis or estimation—the cost of debt for a benchmark BBB+ rated 10 year Australian corporate bond even though no such bonds were on issue with directly observable yields.

Given this interpretation, Mr Mountain appears to confuse the term 'observed' in the NER with 'directly observed'. This confusion may lead Mr Mountain to conclude (incorrectly) that a greater degree of reliance should be placed on historic values for the actual cost of debt rather than a benchmark cost of debt.

3.2 Swap rates and the cost of debt to DNSPs

The 90-day bank bill swap rate, plus the margin over the benchmark for the particular loan, is assumed to represent the cost of debt facing DNSPs. However, as Mr Mountain acknowledges, this is an unrealistic assumption, since in most cases distributors swap their exposure to short-term bonds for fixed rates.²⁷ Also, this swap rate reflects the credit risks between banks, rather than the credit risks of a benchmark DNSP. Accordingly, Mr Mountain's analysis is inconsistent with the NER, which requires the cost of debt to be calculated by reference to the benchmark corporate bond rate.

PwC note that:²⁸

in relation to the debt risk premium from the floating rate debt issues, Mountain observes correctly on page 7 of his report that the results he sets out in Table 1 on page 6 assumes that the relevant firm would choose to remain exposed to movements in underlying interest rate (in these cases, the Bank Bill Swap Rate), which he notes is not standard practice for utility firms. This observation alone means that the results set out in Table 1 would not reflect the actual cost of debt for a utility firm. In addition, as floating rate interest rates vary over time, it cannot be assumed that the total interest rate reported in Table 1 would remain constant over the term of the debt instrument even if the firm in question remained exposed to a floating interest rate.

Mr Mountain attempts to correct for this and derive an alternative estimate; however the methodology used to derive the alternative estimate is opaque and potentially flawed. PwC attempt to replicate this estimate and find that the correct interpretation of the observed yields on Mr Mountain's sample of bonds is an average debt risk premium of 298 basis points (not 36 or 137 basis points as reported in the Mountain Report).²⁹

Further, as PwC point out:³⁰

The debt risk premium reported above assumed that floating rate issues would be 'swapped' in order to fix the interest rate for a period. An additional credit margin would be payable on this swap transaction (this compensates the swap bank for the risk that the counter-party may default and leave it with an imbalanced swap portfolio). Based upon recent transactions, we estimate that this credit margin would be in the order of 5 to 15 basis points (per annum). A further additional fee again may be payable for very large swap transactions (reflecting the fact that the swap bank may not be able to buy the instruments necessary to offset its own risk at the mid-rate).

²⁵ AER, *Victorian advanced metering infrastructure review: 2009-11 AMI budget and charges applications – Final Determination*, October 2009, Appendix A, p. 117.

²⁶ Ibid.

²⁷ Mountain Report, p. 7.

²⁸ PwC, *Review of the Debt Risk Premium in the Mountain Report*, 22 September 2010, p. 3.

²⁹ PwC, *Review of the Debt Risk Premium in the Mountain Report*, 22 September 2010, p. 4.

³⁰ PwC, *Review of the Debt Risk Premium in the Mountain Report*, 22 September 2010, p. 4.

3.3 Definition of DRP

Mr Mountain calculates the DRP for floating rate bond issues of various maturities by subtracting (a) the 10 year risk-free rate (set in the AER draft decision) from (b) the fixed rate equivalent of these bonds. This definition mixes the maturity on the risk-free rate with the maturity of these bonds and tends to understate the DRP for bonds with maturities less than 10 years.

PwC note that, by calculating the DRP as the premium over a 10 year risk free rate, Mr Mountain implicitly makes two assumptions—both of which are untrue:³¹

the risk free rate of return is constant with term of debt so that any change in the total cost of debt must translate into a change in the debt risk premium

and:

the risk free rate of return is also constant over time so that any change in the total cost of debt over time must also translate into a change to the debt risk premium.

As discussed above, the NER requires that the DRP be measured as the premium over the CGS bond rate with the same term as the debt instrument in question. As PwC note:³²

This definition ensures that any change in the total interest rate that is caused by changes in Commonwealth Government bond rates (either with the term of the bond or the time of observation) is not wrongly attributed to a change in the margin. This definition is also the common and accepted usage of the term 'debt risk premium' in Australia (albeit noting that the swap rate is often used as the base interest rate).

Based on his DRP definition, Mr Mountain calculates an average DRP for eight recent utility floating-rate debt issues of 36 or 137 basis points, depending on whether these issues are swapped into fixed rate equivalents.³³

But by adopting the correct definition for those issues swapped into fixed rate equivalents, the DRP rises significantly to 298 basis points.³⁴ Further, given that these issues had an average term to maturity of 3.6 years, the DRP for 10 year fixed rate debt should be materially higher.³⁵

3.4 Averaging period

Mr Mountain calculates the DRP using the costs of debt at issue for a sample of floating rate debt issues that were issued in periods outside of the averaging periods for each Joint DB, which is inconsistent with the NER and the SORI.

The NER and SORI require that the DRP for each DNSP is calculated over an agreed averaging period that is as close as practically possible to the start of the regulatory control period.³⁶ For the Joint DBs, these averaging periods fall from 19 April 2010 onwards. However, Mr Mountain calculates the DRP using a sample of floating rate debt issues that were each issued prior to this date, with the latest issue being 5 February 2010.³⁷ Accordingly, by relying on the costs of debt *at issue* for these debt issues, Mr Mountain's alternative approach fails to satisfy the NER and SORI.

The Joint DBs submit that the AER should calculate the DRP for each DNSP using only observed yields that are current to their respective averaging periods.

³¹ PwC, *Review of the Debt Risk Premium in the Mountain Report*, 22 September 2010, p. 3.

³² PwC, *Review of the Debt Risk Premium in the Mountain Report*, 22 September 2010, pp. 3–4.

³³ Mountain Report, Table 1, p. 6.

³⁴ PwC, *Review of the Debt Risk Premium in the Mountain Report*, 22 September 2010, p. 4 and Appendix A.

³⁵ PwC, *Review of the Debt Risk Premium in the Mountain Report*, 22 September 2010, p. 4 and Appendix A.

³⁶ AER, *Electricity transmission and distribution network service providers: Review of the weighted average cost of capital (WACC) parameters – Final Decision*, May 2009, pp170-171

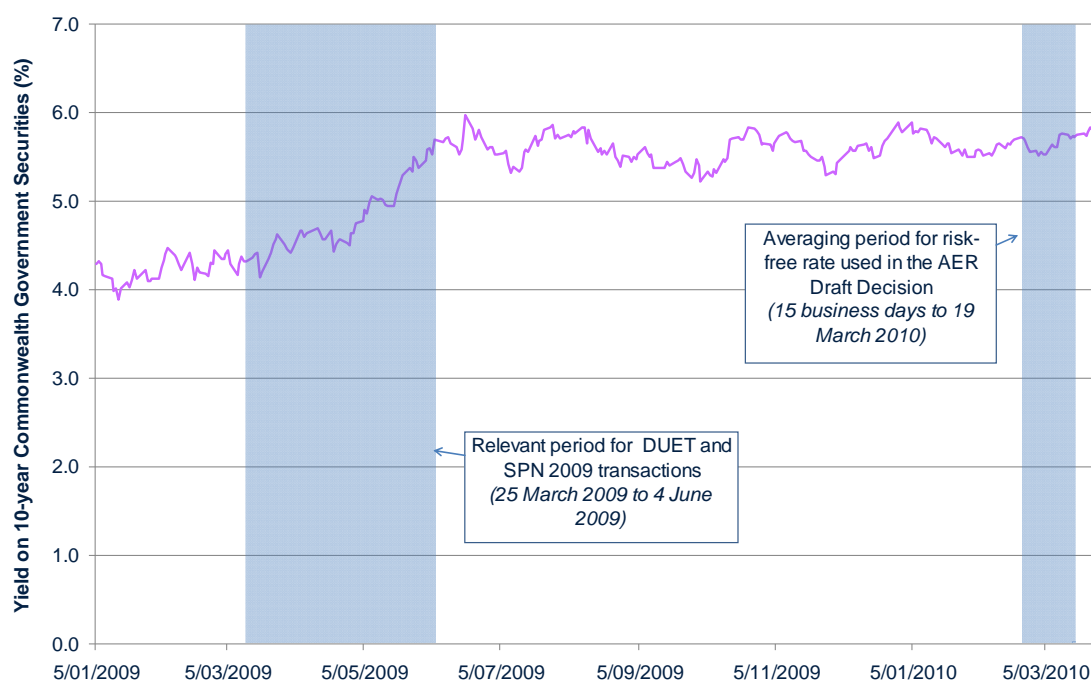
³⁷ PwC, *Review of the Debt Risk Premium in the Mountain Report*, 22 September 2010, Appendix A.

3.5 Yield estimates measured over different periods

The risk-free rate is measured at a single point in time (the draft decision averaging period), even though the cost of debt estimates are from different periods. Mr Mountain suggests that this assumption leads to an overstatement of the debt margin, since the risk free rate was actually higher in the earlier periods from which the cost of debt estimates are drawn.³⁸

However, this suggestion is false—the yields on 10-year Government bonds were in fact significantly lower for the early part of 2009 as monetary policy was eased to deal with the global financial crises (GFC) and there was a flight to safety among investors (see Figure 1). As a result, the risk free rate determined by the AER in its Final Decision for the NSW distributors (based on a March 2009 averaging period) was around 135 basis points below that determined in the recent draft decision for Victoria.³⁹

Figure 1: Yield on 10-year CGS, January 2009 to March 2010



Source: Reserve Bank of Australia, statistical table F16 – Indicative Mid Rates of Commonwealth Government Securities, AER draft decision, and the Mountain Report.

Note: The 'yield' is the equivalent annual yield (EAY) on Commonwealth Government Securities (CGS), consistent with the approach to calculating the 10 year risk-free rate in the AER draft decision. For a given day, this yield is calculated by (a) interpolating the bond equivalent yields (BEYs) on CGSs that mature either side of 10 years from that date and then (b) converting this BEY to an EAY.

³⁸ Footnote 4 of the Mountain Report states: "For the sake of brevity, the risk free rate that the AER is likely to have determined at the date that each loan was issued will vary from the values in this column (which are based on the AER's determination of the risk free rate in the Draft Decision). However, over the period of time covered in this table – particularly around the peak of the GFC at the start of 2009 - the risk free rate was higher than the value in the penultimate column. As such, the average premium that we have calculated is likely to overestimate the average DRP that would be calculated based on the 10 year risk free rates that applied when the loans were issued." This statement is clearly untrue—as Figure 1 demonstrates, the yield on 10-year CGS was in fact lower at the start of 2009.

³⁹ In its Final Decision, the AER set a risk free rate of 4.29% for EnergyAustralia and Country Energy (based on a February 2009 averaging period) and a risk free rate of 4.32% for Integral Energy (based on a March 2009 averaging period). On appeal, the Australian Competition Tribunal adopted an earlier averaging period, resulting in a higher risk free rate.

3.6 *DRP for APT Pipelines bond*

Mr Mountain calculates a DRP of 125 basis points for the APT Pipelines bond that was issued on 15 July 2010. PwC were unable to replicate this value and consider that Mr Mountain's calculation contains material error.⁴⁰ Rather, PwC estimate the DRP for the APT Pipelines bond at 304 basis points, which is substantially higher.

PwC's calculations are shown in Table 2 of its opinion, but Mr Mountain's calculations are not available for validation.

⁴⁰ PwC, *Review of the Debt Risk Premium in the Mountain Report*, 22 September 2010, p. 4 and Appendix.

4 Regulatory precedent

Mr Mountain suggests that his arguments are supported by regulatory precedent. Table 2 of the Mountain Report presents the outcomes of various decisions, some of which set a DRP lower than that set in the AER draft decision.

However, the Joint DBs consider that these precedents do not support these arguments, irrespective of whether they are from Australian or international regulatory decisions.

4.1 Australian precedents

Whilst the results of older decisions are emphasised by Mr Mountain, the two most relevant decisions in Table 2 are largely ignored. Only two decisions from the past three years are listed in the Mountain Report, and both these decisions set a DRP of at least 330 basis points. Other decisions in this recent time period (not listed in the Mountain Report) have set DRPs of a similar magnitude.⁴¹ The older decisions listed are largely irrelevant, since they relate to much earlier time periods when financial market conditions were different. Importantly, all of these earlier decisions pre-date the onset of the GFC.

In any event, it is not clear why such precedent should be given any weight by the AER. The AER's task is to determine a forward looking rate of return that is commensurate with prevailing conditions in the market for funds.⁴² Generally, this task does not require consideration of market conditions from over a decade ago. The AER's past practice has not been to base its determination of the DRP on "precedent", and there is no reason why it should entertain such a practice now. Consideration of historical conditions is neither required by the NER, nor appropriate in the current circumstances.

4.2 Ofgem precedent

The Ofgem precedent cited by Mr Mountain also does not appear relevant to the AER's determination of the cost of debt. As noted above, the NER require the DRP to be determined by reference to the Australian benchmark corporate bond rate and, under the SORI, this is to reflect BBB+ corporate bonds with a 10 year maturity.

Precedent from different jurisdictions and different time periods (particularly a time period when financial markets were in a state of flux) is not relevant to the determination of the cost of debt under the NER, unless there is something else that suggests otherwise. Mr Mountain does not deal with how an approach taken by a regulator in a different country, such as Ofgem, with a different statutory framework is relevant to the process of determining the cost of debt for an Australian DNSP under the NER.

⁴¹ For example, the AER's Final Distribution Determination for South Australia set a DRP of 298 basis points, and the transmission determination for TransGrid (as varied by the Australian Competition Tribunal) set a DRP of 299 basis points.

⁴² NER, clause 6.5.4(e)(1).

Appendix A—PwC Opinion Letter

Review of the Debt Risk Premium Estimates in the Mountain Report

PricewaterhouseCoopers

22 September 2010

Mr Jeremy Rothfield
Economist and Regulatory Analyst
United Energy Distribution and Multinet Gas
Level 3, 501 Blackburn Road
Mount Waverley, Victoria 3149

22 September 2010

Dear Jeremy,

Review of the Debt Risk Premium Estimates in the Mountain Report

1. Introduction and summary of conclusions

Brief

We refer to our terms of reference dated 3 September 2010 in which you sought our expert opinion on certain calculations that were presented in the expert report from Bruce Mountain of Carbon Market Economics (Mountain Report), namely:

1. Whether you consider the calculation of the actual cost of debt in section 6.1 of the Mountain Report to be methodologically sound; and
2. To the extent that there may be flaws in this methodology, how these can be corrected and, if the flaws are corrected, what the outcome of the corrections will be.

This note has been prepared in the context of the AER's task, which is to determine a debt risk premium that is:¹

the margin between the annualised nominal risk free rate and observed annualised Australian benchmark corporate bond rate for corporate bonds which have a maturity equal to that used to derive the nominal risk free rate and a credit rating from a recognised credit rating agency

and where the term is 10 years and the assumed credit rating is BBB+.²

¹ NER, clause 6.5.2(e).

² AER, 2009, Statement of Regulatory Intent on the Revised WACC Parameters, April, clauses 3.3 and 3.5.

Summary of conclusions³

We consider that the calculation of the actual cost of debt in section 6.1 of the Mountain Report includes several flaws and is not methodologically sound. We identify the following flaws:

- Mountain's concludes that the recent utility floating rate debt issues (reported on pages 6 and 7 of his report) imply an average debt risk premium of either **36 basis points** or **137 basis points** (the latter assumes that the floating interest rate is swapped to a fixed interest rate for the term of the issue). This conclusion provides misleading information about the debt risk premium that is required by the National Electricity Rules and the AER's Statement of Regulatory Intent. It also uses the term 'debt risk premium' in a manner that is inconsistent with its common and accepted usage.
 - Our view is that the same debt raisings imply an average debt risk premium of **298 basis points**.
 - Furthermore, all except one of these debt issues was bank debt. With debt raised from banks, in addition to the margin the borrower is also required to pay an upfront establishment fee to the bank. This upfront component needs to be added to the figure above derive a debt risk premium that is comparable to a corporate bond, which would be in the order of 10 to 40 basis points (per annum). In addition, swap costs also would be incurred to covert the floating rate debt to a fixed interest rate equivalent (and hence comparable to corporate bonds), which would add an amount in the order of 5 to 15 basis points (per annum), and possibly execution costs in addition.
- Mountain's observation that the issue yield for the APT Pipelines corporate equates to **125 basis points** above the AER's risk free rate suffers from material error.
 - We calculate that the APT Pipelines bond implied a debt risk premium of **304 basis points**.

We also observe at the outset that none of the debt issues that Mountain surveys are for BBB+ rated debt (the ratings of each issue are set out in Appendix A), but we do not address the implications of this matter further in this note.

2. The Mountain Report

The Mountain Report provides three sets of results in section 6.1, which are as follows:

- The cost of debt is observed for eight recent utility floating-rate debt raisings, and this is reported to produce an average debt risk premium of **36 basis points** (with a range of between -1 basis point and 108 basis points).⁴
 - This implied debt risk premium is defined as the yield on the floating rate debt at the time of issue less the 10 year risk free rate that the AER adopted in the draft decision. We have been able to (approximately) replicate this calculation.

³ All interest rates are reported as the equivalent effective annual interest rates.
⁴ Mountain Report, Table 1, p.6.

- If the same floating-rate debt raisings were assumed to be ‘swapped’ so that the floating interest rate is converted into a fixed interest rate for the term of the loan, then an implied debt risk premium of **137 basis points** would be observed.
 - This implied debt risk premium is calculated as for the floating rate debt, except that the debt is assumed to be swapped at the time of issue (that is, the difference between the 90 day swap rate and the swap rate that has the same term as the debt instrument is added to the yield. We have been able to (approximately) replicate this calculation.
- The cost of debt observed in the APT Pipelines bond issue – which were fixed rate bonds – generated an implied debt risk premium of **125 basis points**.
 - We have been unable to replicate this calculation and consider that it contains material errors. This is discussed further below.

3. Analysis

In our view, Mountain’s results provide misleading information about the debt risk premium that is required by the National Electricity Rules and the AER’s Statement of Regulatory Intent. We also consider that Mountain’s use of the term ‘debt risk premium’ is inconsistent with its common and accepted usage.

Floating rate issues

First, in relation to the debt risk premium from the floating rate debt issues, Mountain observes correctly on page 7 of his report that the results he sets out in Table 1 on page 6 assumes that the relevant firm would choose to remain exposed to movements in underlying interest rate (in these cases, the Bank Bill Swap Rate), which he notes is not standard practice for utility firms. This observation alone means that the results set out in Table 1 would not reflect the actual cost of debt for a utility firm. In addition, as floating rate interest rates vary over time, it cannot be assumed that the total interest rate reported in Table 1 would remain constant over the term of the debt instrument even if the firm in question remained exposed to a floating interest rate.

Secondly, in relation to the floating rate issues that have been swapped into fixed rate terms, the fact that Mountain has calculated the debt risk premium as the premium over the AER 10 year risk free rate from the draft decision assumes implicitly that:

- the risk free rate of return is constant with term so that any change in the total cost of debt as the terms to maturity changes must translate into a change in the debt risk premium – which is clearly untrue; and
- the risk free rate of return is also constant over time so that any change in the total cost of debt over time must also translate into a change to the debt risk premium – which is also untrue.

Rather, the measurement of the ‘debt risk premium’ that is relevant to the National Electricity Rules requirements summarised above is the premium over the Commonwealth Government bond rate with the same term as the debt instrument in question. This definition ensures that any change in the total interest rate that is caused by changes in Commonwealth Government bond rates (either with the term of the bond or the time of

observation) is not wrongly attributed to a change in the margin.⁵ This definition is also the common and accepted usage of the term 'debt risk premium' in Australia (albeit noting that the swap rate is often used as the base interest rate).

The correct interpretation of the floating rate debt financings that Mountain surveyed is that an average debt risk premium of **298 basis points** was observed (with a range of 181 basis points to 441 basis points), rather than 36 basis points or 137 basis points that Mountain reported. Moreover, as these financings had an average term of 3.6 years, we would infer that the debt risk premium for 10 year fixed rate debt would most likely have been materially higher.

Our calculations of these results are set out in Appendix A.

In addition, we would note the following:

- All except the first of the debt raisings referred to in Table 1 were bank debt. With bank debt, part of the bank's return requirement is paid to the participating banks in the form of an upfront establishment fee. This fee needs to be added to the premiums reported above in order to make that margin consistent with the margin observed on corporate bonds. Based upon the amounts paid in recent transactions, we estimate that this additional upfront payment would have been in the order of 10 to 40 basis points (per annum).
- The debt risk premium reported above assumed that floating rate issues would be 'swapped' in order to fix the interest rate for a period. An additional credit margin would be payable on this swap transaction (this compensates the swap bank for the risk that the counter-party may default and leave it with an imbalanced swap portfolio). Based upon recent transactions, we estimate that this credit margin would be in the order of 5 to 15 basis points (per annum). A further additional fee again may be payable for very large swap transactions (reflecting the fact that the swap bank may not be able to buy the instruments necessary to offset its own risk at the mid-rate).

Fixed rate bond issue

Mountain refers to the APT Pipelines 10 year Australian corporate bond and correctly observes that this bond was issued at 240 basis points above the swap rate. However, Mountain then concludes that this equates to 125 basis points above the AER's risk free rate.

- We have been unable to replicate Mountain's calculation. We hypothesised that Mountain may have confused the quoted credit margin for the bond as being expressed over the 90 day swap rate rather than the 10 year swap rate (the latter of which is correct). However, if this error had been made then Mountain should have derived a debt risk premium of 165 basis points.

We calculate that the APT Pipelines bond was issued at **304 basis points** above the Commonwealth Government bond rate with a term matching that of the bond (which was also the 10 year Commonwealth Government bond as the term was 10 years).

⁵ Note that the margin measured in this manner provides an observation of the margin that reflects the term of the relevant debt instrument. A separate and more complex question is how that margin (as well as the risk free rate) is expected to vary with the term of debt.

4. Declarations

As a professional services firm, PwC has an ongoing relationship with each of the Victorian electricity distribution businesses. This relationship includes advising on matters pertaining to the upcoming regulatory review; the subject of this report. Further details of PwC's relationship with the businesses can be provided if necessary.

We confirm that, in preparing this report, we have made all the inquiries that we believe are desirable and appropriate and that no matters of significance that we regard as relevant have, to our knowledge, been withheld. We have been provided with a copy of the Federal Court's *Guidelines for Expert Witnesses in Proceedings in the Federal Court of Australia* and this report has been prepared in accordance with those Guidelines.

Appendix B sets out the curriculum vita of the authors of this report and Appendix C attaches our terms of reference.

* * *

Yours sincerely,



Jeff Balchin
Executive Director
Advisory



Matt Santoro
Executive Director
Advisory

PricewaterhouseCoopers is committed to providing our clients with the very best service. We would appreciate your feedback or suggestions for improvement. You can provide this feedback by talking to your engagement partner, calling us within Australia on 1300 792 111 or visiting our website <http://www.pwcfeedback.com.au/>

The Mountain Report concluded that the debt risk premium observed in eight debt raisings from distribution businesses over the period 10 Nov 2008 to 5 Feb 2010 ranged from -1 basis points to 108 basis points, with an average of 36 basis points (Table 1, page 6). These eight debt raisings (one of which comprised two tranches, implying nine issues in total) are summarised under the heading 'floating rate debt' in the following two tables.

The Mountain Report also reported upon the yield at issue of the recent APT Pipelines corporate bond issue. Our analysis of this debt raising is summarised under 'fixed rate debt' in the following two tables.

The first table summarises the 'raw data' of the debt raisings while the second table calculates the debt risk premium implied by the debt raising as commonly understood. The calculation that we adopt in the second table uses the following methodology (consistent with market practice) to calculate the debt risk premium above the Commonwealth Government bond rate:

- Debt risk premium = Swap mid-rate + Credit margin – Commonwealth Government bond rate, where:
 - the swaps are based on the mid-point of the bids and offers for fixed rates corresponding to the term of the relevant loan at the time of the transaction announcement; and
 - the Commonwealth Government bond rate is based on the rate corresponding to the term of the relevant loan at the time of the transaction announcement.

We have used Bloomberg as the data source for the swap mid rate and for the Commonwealth Government bond rate, using the closing rates on the day of the transaction. The Commonwealth Bond rate that has been employed in the analysis reflects the Bloomberg fair value yield for the Commonwealth Government bond with a term that is the same as the debt issue, or linearly interpolated between the fair value yields that correspond to the closest terms that straddle the term of the bond in question.

The formula that we have used to convert the quoted interest rates (QIR) to the equivalent effective annual rates (EAR) is as follows:

$$EAR = \left(1 + \frac{QIR}{2}\right)^2 - 1$$

where both interest rates are expressed as a percentage.

Table 1 – Summary of debt raisings

Borrower / S&P rating at time of debt raising	Date announced	Term (years)	Amount	Funding source	Description	Pricing	Source
Floating rate debt							
SP AusNet (A-/Stable)	5 Feb 2010	5.5 yrs	CHF475m / A\$520m	Swiss bond issue	Swiss bond issue, swapped back into A\$ (floating)	Swapped back to A\$ BBSW + 1.52%	- Company ASX announcement
SP AusNet (A-/Stable)	4 Jun 2009	3 yrs	A\$50m	Bank	Raised total of A\$325m bilateral bank facilities in month of May 2009 (part of below broader raising of bilateral bank facilities)	Approx BBSW + 2.50%	- Company ASX announcement - LoanConnector
SP AusNet (A-/Stable)	7 May 2009	3 yrs	A\$275m	Bank	Raised total of A\$325m bilateral bank facilities in month of May 2009 (part of above broader raising of bilateral bank facilities)	Approx BBSW + 2.50%	- Company ASX announcement - LoanConnector
Dampier to Bunbury Pipeline (part of DUET) (BBB-/Stable)	29 Apr 2009	3 yrs	A\$ 264m	Bank	Part of A\$480m 3 and 5 year tranching bank facility (related to below raising)	BBSW + 3.25%	- Company ASX announcement - LoanConnector for pricing
Dampier to Bunbury Pipeline (part of DUET) (BBB-/Stable)	29 Apr 2009	5 yrs	A\$216m	Bank	Part of A\$480m 3 and 5 year tranching bank facility (related to above raising)	BBSW + 3.75%	- Company ASX announcement - LoanConnector for pricing
Multinet / EPG (part of DUET) (BBB-/Stable)	25 Mar 2009	3 yrs	A\$100m	Bank	Bank bilateral facility	BBSW + 2.85%	- Company ASX announcement - Pricing sourced from Credit Suisse broker report dated 8 February 2010.
United Energy Distribution (part of DUET) (BBB-/Stable)	9 Dec 2008	5 yrs	A\$150m	Bank	Bank bilateral facilities	BBSW + 2.20%	- Company ASX announcement - Pricing sourced from Credit Suisse broker report dated 8 February 2010.

SPARK Infrastructure (49% interest in ETSA and CitiPower) (Not rated)	10 Nov 2008	A\$50m 2yrs A\$50m 3 yrs	A\$50m 2yrs A\$50m 3 yrs	Bank	Bank debt facility – at holding company level (not at asset level)	Average of BBSW + 1.025% for both facilities	- Company ASX announcement
Fixed rate debt							
APT Pipelines (BBB/Stable)	15 Jul 2010	10 yrs	A\$300m	Aus Bond	A\$300m 10 yr medium term note.	10 yr mid swap + 2.40%	- Company ASX announcement

Table 2 – Calculation of the debt risk premium

Borrower / (credit rating)	Date Announced	Term (yrs)	Margin (%)	Swap mid-rate (%)	Total Rate (%)	Total Rate – Effective Annual (%)	Govt Bond (%)	Govt Bond – Effective Annual (%)	Debt risk premium (%)
<i>Floating rate debt</i>									
SP AusNet (A-/Stable)	5/02/2010	5.5	1.52	5.60	7.12	7.25	4.97	5.03	2.22
SP AusNet (A-/Stable)	4/06/2009	3	2.50	4.45	6.95	7.07	4.08	4.12	2.95
SP AusNet (A-/Stable)	7/05/2009	3	2.50	4.27	6.77	6.88	3.87	3.91	2.97
Dampier to Bunbury Pipeline (BBB-/Stable)	29/04/2009	3	3.25	3.93	7.18	7.31	3.44	3.47	3.84
Dampier to Bunbury Pipeline (BBB-/Stable)	29/04/2009	5	3.75	4.55	8.30	8.47	4.03	4.07	4.40
Multinet / EPG (BBB-/Stable)	25/03/2009	3	2.85	3.88	6.73	6.84	3.40	3.42	3.41
United Energy Distribution (BBB-/Stable)	9/12/2008	5	2.20	4.75	6.95	7.07	3.78	3.81	3.26
Spark Infrastrucuture (Not Rated)	10/11/2008	2	1.03	4.58	5.60	5.68	3.83	3.87	1.81
		3	1.03	5.02	6.04	6.14	4.17	4.21	1.92
Average (floating rate debt)						6.97		3.99	2.98
<i>Fixed rate debt</i>									
APT Pipelines (BBB-/Stable)	15/07/2010	10	2.40	5.64	8.04	8.20	5.10	5.17	3.04

CURRICULUM VITA OF THE AUTHORS



Jeff Balchin

Executive Director

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Jeff is an economist in the PwC Economics team. Jeff has over 17 years of experience in relation to economic regulation issues across the electricity, gas, airports, ports and water industries in Australia and New Zealand. He has advised governments, regulators and major corporations on issues including the development of regulatory frameworks, regulatory price reviews, licensing and franchise bidding and market design. Jeff has also undertaken a number of expert witness assignments. His particular specialities have been on the application of finance principles to economic regulation, the design of incentive compatible regulation and the drafting and economic interpretation of regulatory instruments. His experience is outlined below in more detail.

Prior to joining PwC Jeff was a Director with the Allen Consulting Group, where he built a consulting practice with a strong specialisation in the economic regulation of price and service and prior to that he held a number of policy positions in the Commonwealth Government.

Qualifications and professional/business associations

- Bachelor Economics (First Class Honours) University of Adelaide

Relevant Experience

- *Strategic advisor to regulators and regulated businesses* – he has been a strategic adviser on economic regulation issues to regulators during a number of major price reviews, including the Victorian 2008, 2003 and 1998 gas distribution price reviews, the Victorian 2006 and 2001 electricity distribution price reviews, the South Australian 2006 gas distribution price review and the South Australian 2005 electricity distribution price review. He has also been retained by regulated businesses to provide strategic advice during major regulatory reviews, including to the electricity transmission businesses during the AEMC review of the revenue setting rules (2005/6), Jemena during its current gas and electricity reviews and a major NZ energy business and airport.
- *Finance issues* – he has provided advice on a range of finance issues to regulators and regulated businesses, including a major review of equity betas for the ACCC in 2001, a further study for the Victorian ESC in 2008 and then for the network industry associations in 2008/9. He has also advised on benchmark cost of debt and credit rating issues for regulated entities. He has provided extensive advice to NZ utilities in relation to deriving an allowance for taxation that is consistent with the various 'benchmark' assumptions made by the regulator. He has also provided substantial advice in relation to regulatory asset valuation and depreciation issues. He has also advised in relation to cost allocation issues (and the related issue of treatment of related party arrangements) to regulators and regulated businesses.
- *Cost benefit studies* – he has advised in relation to methodological issues in quantifying the economic costs and benefits of electricity transmission investment during applications for conversion of unregulated transmission interconnectors, and more recently advised the AEMC on how the CPRS and expanded RET should be treated when assessing the costs and benefits of projects. He has also advised in relation to the economic benefits of IT projects to make expanded use of advanced metering infrastructure.
- *Incentive regimes* – he has advised on the design of incentives for regulated businesses to minimise cost, undertake efficient service improvement and on the design of price controls (an objective of which is to create an incentive for firms to structure prices efficiently).

Matthew Santoro

Executive Director



Qualifications and memberships:

- Bachelor of Economics (Honours), University of Adelaide
- Affiliate, Institute of Chartered Accountants

Matthew has over 20 years of corporate and institutional banking experience, including 12 years at Deutsche Bank and eight years at Citibank. At Deutsche Bank he held various senior banking positions covering the origination, structuring and syndication of debt facilities. Following this and prior to joining PwC, Matthew jointly established and was Joint National Head of KPMG's debt advisory practice for a period of five years.

Project experience:

Matthew is experienced in a wide range of financing and fundraising transactions, in particular in the area of acquisition financing, leverage financing, re-financings, project and property financing and procurement of debt capital markets instruments across the Australian, European and USA markets. His experience includes dealings with credit rating agencies such as Standard & Poor's and Moody's.

Matthew has advised numerous companies on their debt and capital management needs, including the procurement of debt across a very broad industry sector. His clients have included the following:

- CSL
- David Jones
- Boom Logistics
- Pacific Brands
- Healthscope
- Hastings Funds Management
- Future Fund
- Australian Super
- Deutsche Asset Management
- South East Water
- Computershare
- ORIX Corporation
- Toll Holdings, and
- Tabcorp

Matthew's experience covers capital management and financing applications for a wide range of structures, asset types and industries. Matthew has over 20 years of debt markets experience with extensive dealings and established relationships with key participants in the capital markets such as banks, borrowers, fund and fixed interest managers, private equity investors, credit rating agencies, legal firms, etc.

Matthew's sector experience includes:

- debt structuring, arranging and procurement, onshore and offshore
- US Private Placement, Australian and European Bond markets
- capital management, and
- credit rating agencies.

TERMS OF REFERENCE



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3rd September 2010

Our Reference: UE-SU-01

By email: Jeff.Balchin@au.pwc.com

Mr Jeff Balchin
Executive Director
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Australia

Dear Mr Balchin,

Expert opinion on calculation of the debt risk premium

As you would be aware, the Australian Energy Regulator (**AER**) is currently conducting its five-yearly review of pricing proposals submitted by the five Victorian electricity distribution business, United Energy, Citipower, Powercor, Jemena and SP Ausnet (**the Victorian DBs**). The AER released its Draft Decision in June 2010 and has since received submissions from interested parties.

The AER has received a submission in response to its Draft Decision from the Energy Users Association of Australia (**EUAA**) enclosing an expert report from Bruce Mountain of Carbon Market Economics (**Mountain Report**). One of the arguments made in the Mountain Report is that the cost of debt determined by the AER in its Draft Decision is not reflective of, and is, in fact, considerably higher than, the actual cost of debt faced by the Victorian DBs. The Mountain Report seeks to support this argument with an analysis of several recent debt transactions undertaken by the Victorian DBs.

In this context, the Victorian DBs request your expert opinion on the following matters:

- 1) Whether you consider the calculation of the actual cost of debt in section 6.1 of the Mountain Report to be methodologically sound; and
- 2) To the extent that there may be flaws in this methodology, how these can be corrected and, if the flaws are corrected, what the outcome of the corrections will be.

Guidelines in preparing your report

Attached are Expert Witness Guidelines issued by the Federal Court of Australia. Although this brief is not in the context of litigation, the Victorian electricity distribution businesses are seeking a rigorously prepared independent view for use in the context of regulatory decision making, and you are requested to follow the Guidelines to the extent reasonably possible in the context.

In particular, please:

- a) Identify your relevant area of expertise and provide a curriculum vitae setting out the details of that expertise;
- b) only address matters that are within your expertise;
- c) where you have used factual or data inputs please identify those inputs and the sources;
- d) if you make assumptions, please identify them as such and confirm that they are in your opinion reasonable assumptions to make;
- e) if you undertake empirical work, please identify and explain the methods used by you in a manner that is accessible to a person not expert in your field;
- f) confirm that you have made all the inquiries that you believe are desirable and appropriate and that no matters of significance that you regard as relevant have, to your knowledge, been withheld from your report; and
- g) please do not provide legal advocacy or argument and please do not use an argumentative tone.

Your fees

All invoices for this work should be sent to Jeremy Rothfield at United Energy. If you have any questions regarding invoicing or any other aspect of this engagement please contact Jeremy.

Yours sincerely,



Jeremy Rothfield
Regulatory Economist

FEDERAL COURT OF AUSTRALIA

Practice Note CM 7

EXPERT WITNESSES IN PROCEEDINGS IN THE FEDERAL COURT OF AUSTRALIA

1. Practitioners should give a copy of the following guidelines to any witness they propose to retain for the purpose of preparing a report or giving evidence in a proceeding as to an opinion held by the witness that is wholly or substantially based on the specialised knowledge of the witness (see **Part 3.3 - Opinion** of the *Evidence Act 1995* (Cth)).
2. The guidelines are not intended to address all aspects of an expert witness's duties, but are intended to facilitate the admission of opinion evidence¹, and to assist experts to understand in general terms what the Court expects of them. Additionally, it is hoped that the guidelines will assist individual expert witnesses to avoid the criticism that is sometimes made (whether rightly or wrongly) that expert witnesses lack objectivity, or have coloured their evidence in favour of the party calling them.

Guidelines

1. General Duty to the Court²

- 1.1 An expert witness has an overriding duty to assist the Court on matters relevant to the expert's area of expertise.
- 1.2 An expert witness is not an advocate for a party even when giving testimony that is necessarily evaluative rather than inferential³.
- 1.3 An expert witness's paramount duty is to the Court and not to the person retaining the expert.

2. The Form of the Expert Evidence⁴

- 2.1 An expert's written report must give details of the expert's qualifications and of the literature or other material used in making the report.
- 2.2 All assumptions of fact made by the expert should be clearly and fully stated.

¹ As to the distinction between expert opinion evidence and expert assistance see *Evans Deakin Pty Ltd v Sebel Furniture Ltd* [2003] FCA 171 per Allsop J at [676].

² See rule 35.3 Civil Procedure Rules (UK); see also Lord Woolf "Medics, Lawyers and the Courts" [1997] 16 CJQ 302 at 313.

³ See *Sampi v State of Western Australia* [2005] FCA 777 at [792]-[793], and *ACCC v Liquorland and Woolworths* [2006] FCA 826 at [836]-[842]

⁴ See rule 35.10 Civil Procedure Rules (UK) and Practice Direction 35 – Experts and Assessors (UK); *HG v the Queen* (1999) 197 CLR 414 per Gleeson CJ at [39]-[43]; *Ocean Marine Mutual Insurance Association (Europe) OV v Jetopay Pty Ltd* [2000] FCA 1463 (FC) at [17]-[23]

- 2.3 The report should identify and state the qualifications of each person who carried out any tests or experiments upon which the expert relied in compiling the report.
- 2.4 Where several opinions are provided in the report, the expert should summarise them.
- 2.5 The expert should give the reasons for each opinion.
- 2.6 At the end of the report the expert should declare that “[the expert] has *made all the inquiries that [the expert] believes are desirable and appropriate and that no matters of significance that [the expert] regards as relevant have, to [the expert’s] knowledge, been withheld from the Court.*”
- 2.7 There should be included in or attached to the report: (i) a statement of the questions or issues that the expert was asked to address; (ii) the factual premises upon which the report proceeds; and (iii) the documents and other materials that the expert has been instructed to consider.
- 2.8 If, after exchange of reports or at any other stage, an expert witness changes a material opinion, having read another expert’s report or for any other reason, the change should be communicated in a timely manner (through legal representatives) to each party to whom the expert witness’s report has been provided and, when appropriate, to the Court⁵.
- 2.9 If an expert’s opinion is not fully researched because the expert considers that insufficient data are available, or for any other reason, this must be stated with an indication that the opinion is no more than a provisional one. Where an expert witness who has prepared a report believes that it may be incomplete or inaccurate without some qualification, that qualification must be stated in the report (see footnote 5).
- 2.10 The expert should make it clear when a particular question or issue falls outside the relevant field of expertise.
- 2.11 Where an expert’s report refers to photographs, plans, calculations, analyses, measurements, survey reports or other extrinsic matter, these must be provided to the opposite party at the same time as the exchange of reports⁶.

3. Experts’ Conference

- 3.1 If experts retained by the parties meet at the direction of the Court, it would be improper for an expert to be given, or to accept, instructions not to reach agreement. If, at a meeting directed by the Court, the experts cannot reach agreement about matters of expert opinion, they should specify their reasons for being unable to do so.

ME J BLACK
Chief Justice
25 September 2009

⁵ The “*Ikarian Reefer*” [1993] 20 FSR 563 at 565

⁶ The “*Ikarian Reefer*” [1993] 20 FSR 563 at 565-566. See also Ormrod “*Scientific Evidence in Court*” [1968] Crim LR 240