Our Ref: D12/5175
Your Ref:

TRANSEND

20 February 2012

Mr Warwick Anderson
General Manager
Network Regulation
Australian Energy Regulator
GPO Box 520
MELBOURNE VIC 3001

Dear Warwick

Submission to AER's Draft Determination for Aurora Energy Pty Ltd

Transend welcomes this opportunity to lodge a submission in response to the AER's Draft Decision for Aurora for the period 1 July 2012 to 30 June 2017. Transend's particular interest is in relation to the estimation of the overall cost of capital and the debt risk premium, and therefore this submission focuses on these issues.

In relation to the overall cost of capital, Aurora correctly points to the unique conditions in national and international markets which will affect the standard estimation of the cost of equity using CAPM[1].

> "The regulatory framework is focused on returns estimated through application of the Capital Asset Pricing Model (CAPM). In circumstances of temporary financial market instability there is a significant danger that the estimated returns will under-estimate the true cost of equity. This is because the CAPM will work relatively well if a long term MRP and a long term estimate of the RFR are applied, or if a short term MRP is applied in conjunction with a short term (i.e. crisis affected) RFR, but will fail when one of these elements is fixed to the long term while the other is allowed to vary with short term market conditions.
>
> By proposing a long term MRP of 6.00 per cent, and the currently observed (short term) RFR, the AER will underestimate the rate of return required in the market place for funds."

Transend notes that the AER's overarching task is to ensure that the forward looking rate of return must be commensurate with prevailing conditions in the market for funds and the risk involved in providing standard control services. Aurora is correct that the current market conditions, particularly the very low risk free rate, will produce an artificially depressed estimate of the cost of equity unless an appropriate adjustment is made to the standard estimation approach using the CAPM. Aurora's suggestion that the risk free rate should be averaged over a longer period is therefore worthy of very careful consideration by the AER.

1 Aurora Energy, Revised Regulatory Proposal, 2012-2017, page 94.

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Aurora proposed a DRP using Bloomberg's fair value curves (FVC) extrapolated to a term to maturity of 10 years. The AER rejected Aurora's approach, instead preferring an estimate based on the average of observed bond yields[2]:

> "The AER's method to estimate the DRP based on these benchmark parameters is to apply a sample based average of observed market data. The AER considers sufficient market data is now available to form a sample of bonds and to use the observed yields from that sample to determine a reasonable estimate of the benchmark DRP."

The AER excluded the Bloomberg BBB rated FVC from its sample, for the following reasons[3]:

> "The Bloomberg FVC is an estimate made using a proprietary methodology that is neither transparent nor verifiable. Bloomberg stated that the FVC is not a predictive source of price information. It is therefore not consistent with the AER's approach, comprised exclusively of observed bond data.
>
> The Bloomberg 7 year BBB rated FVC (the longest BBB rated FVC currently published) does not currently reflect the available market evidence for long dated bonds, or the stated views of other independent market commentators. The AER considers the Bloomberg BBB rated FVC does not reflect the prevailing cost of debt for the benchmark Australian corporate bond."

Although the AER explained that it will update the DRP at the time of its final determination, the AER's method resulted in a DRP estimate of 3.14% compared to Aurora's proposal of 4.54%[4]:

> "Based on the review of available data, the AER concludes that a DRP of 3.14 per cent satisfies the requirements of the NER. The AER considers its DRP estimate will contribute to a rate of return that promotes efficient investment in Aurora's network, and reflects the regulatory and commercial risks of providing its network services."

Transend notes that the AER has recently made a number of decisions in relation to the DRP which have been successfully appealed by network companies, including ActewAGL and Jemena Gas Networks. In the most recent case, Jemena Electricity Networks (JEN) appealed the AER's decision to estimate the DRP with reference to a single bond issue for APT. The Australian Competition Tribunal reached the following conclusions in its decision[5]:

> "The Tribunal emphasises that it is important for the AER to estimate the DRP and other WACC components with rigour and transparency, using comprehensive market-accepted data and offering some degree of certainty about the way in which it will apply the various estimating formulae (including the DRP formula) to a regulated company. Its estimating practices, data sources and reference periods must be well articulated, consistent and communicated to the parties and must, generally speaking, follow the precedents well-established in previous decisions made by the Tribunal in Application by ActewAGL Distribution and Application by Jemena Gas Networks (NSW) Ltd (No 5).
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> The Tribunal therefore proposes to vary the AER's decision in respect of the DRP pursuant to s 71P of the NEL, in accordance with JEN's proposal to rely only on

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2 AER, Distribution Draft Determination, Aurora Energy Pty Ltd, 2012/2013 – 2016/2017, November 2011, page 216.

3 Ibid, 219.

4 Ibid, 241.

5 Application by United Energy Distribution Pty Limited [2012] ACompT 1 (6 January 2012), paragraphs 461 and 462.

the Bloomberg FV curve for the derivation of the DRP. This produces a DRP of 4.34% for JEN."

In reaching its conclusion, the Tribunal made the following comments in relation to the Bloomberg fair value curve:

> "The Tribunal in *Application by Jemena Gas Networks (NSW) Ltd (No 5)* endorsed the suitability of using only the Bloomberg FV curve to estimate a regulated firm's DRP."[6]
>
> "JEN submitted, and the Tribunal agrees, that it was unreasonable for the AER to reject its proposal to rely only on the Bloomberg FV curve and instead to incorporate also the yield from a single bond which it had not demonstrated in any way to be a relevant benchmark or comparator bond."[7]
>
> "In addition, there was evidence before the AER to show that the Bloomberg fair value curve provided an accurate representation of the yields on benchmark corporate bonds and that it was widely accepted by market practitioners."[8]

Transend notes that the AER has developed a new method for testing and rejecting the Bloomberg fair value curve in its Draft Determination for Aurora. However, the Australian Competition Tribunal's decision in relation to Jemena Electricity Network's appeal makes a number of important findings in support of the Bloomberg fair value curve. On the basis of this appeal decision, it is doubtful that the AER would be able to sustain its current view that the Bloomberg fair value curve is an invalid method for estimating the DRP.

Furthermore, the Australian Competition Tribunal determined that a DRP of 4.34% should be adopted for Jemena Electricity Networks. In its Revenue Proposal, Aurora's proposed methodology resulted in a DRP of 4.54% (as at the time of its proposal), but this methodology was rejected by the AER in favour of a method that provided a DRP of 3.14%.

It is noteworthy that the AER's Draft Determination was published in November 2011, some two months prior to the Australian Competition Tribunal's decision for Jemena Electricity Networks. It is questionable whether the AER could have reasonably rejected Aurora's proposed methodology for the DRP had the AER been aware of the Tribunal's impending decision.

In its Revised Revenue Proposal, Aurora has continued to base its estimate of the DRP on the Bloomberg fair value curve, which resulted in a revised estimate of 3.98%. In presenting its revised proposal, Aurora identified a number of errors in the AER's preferred approach for estimating the DRP[9]:

> "Aurora has replicated most of the AER's estimates, although it found errors (albeit some positive and some negative but which were not material to the outcome) for four of the bonds. Aurora further notes that for some of the bonds there was substantial disagreement between the different information sources as to what the prevailing market yield for the bond actually is. This is reflective of the effects of continued low levels of trade in the corporate bond market, which suggests that caution needs to be exercised when interpreting the corporate bond information."

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6 Ibid, paragraph 431.

7 Ibid, paragraph 434.

8 Ibid, paragraph 436.

9 Aurora Energy, Revised Regulatory Proposal, 2012-2017, page 96.

Transend considers that regulatory stability, consistency and confidence will be promoted if the AER now accepts Aurora's methodology in its Revised Revenue Proposal in relation to the DRP. It would be disappointing if the AER refused to accept that the Bloomberg fair value curve provides a valid methodology for estimating the DRP, even though the Australian Competition Tribunal has persistently reaffirmed its appropriateness in a number of appeal decisions.

Yours sincerely

Bess Clark

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