

17 June 2014

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

Dear Mr. Anderson,

**NSW DNSPs Submission on Return on debt: Choice of third party data service provider Issues Paper**

Thank you for the opportunity to comment on the AER's choice of third party data service provider issues paper. This submission is provided jointly on behalf of Ausgrid, Endeavour Energy and Essential Energy (the NSW DNSPs).

Our submission is intentionally brief as a detailed discussion recommending the Reserve Bank of Australia (RBA) as our choice of third party data service provider is contained in Attachment 7.1 in the Ausgrid, Endeavour Energy and Endeavour Energy substantive regulatory proposals submitted to the AER on 30 May 2014.<sup>1</sup>

We also support the Energy Networks' Association's submission on this matter.

As a general point, we note that using the 10 year trailing average approach (without transition) reduces the potential for individual estimates to bias the allowed return on debt. This is because differences in estimates by service providers tend to 'cancel out' over-time – with differences in methodologies leading to one service provider having a higher estimate at one time and a lower estimate at other times. In contrast, using the return on debt transition approach outlined in the AER's final rate of return guideline is much more sensitive to the choice of data service provider how differences in their estimation methodologies give rise to different estimates in a narrow estimation period.

Based on the available evidence, the NSW DNSPs support the adoption of the RBA data series to estimate the allowed return on debt in energy network determinations. We consider that the RBA's recently published data series for Australian corporate bond yields provides a reliable source for estimates of the required return on debt for benchmark efficient network service providers.

The RBA's December 2013 quarterly bulletin outlined the basis of the RBA's estimates of Australian corporate bond yields and demonstrates that the RBA's estimates are robust for the purposes of providing an estimate of the required return on debt for benchmark efficient energy network service providers.<sup>2</sup>

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<sup>1</sup> See Section 3 of the May 2014 CEG report titled "WACC estimates – A Report for NSW DNSPs", provided as Attachment 7.1 in the Ausgrid, Endeavour Energy and Essential Energy substantive regulatory proposals.

<sup>2</sup> Ivailo Arsov, Matthew Brooks and Mitch Kosev, *New Measures Of Australian Corporate Credit Spreads*, RBA Bulletin, December quarter 2013.

At present, the RBA data series is published monthly and extends back to January 2005. We consider that an average of monthly data is sufficient to calculate a 10 year trailing average estimate of the cost of debt. We note that applying the 10 year trailing average approach immediately as we have proposed in submissions to the AER's rate of return guidelines avoids any need to interpolate monthly observations to infer daily estimates of corporate bond yields.

If the 10 year trailing average approach is applied (without transition), then the RBA's monthly estimates of Australian corporate bond yields would provide a significant number of observations and avoid the need to develop daily estimates of corporate bond yields.

It is worth noting that over the last decade we have had two periods of what can reasonably be referred to as a 'financial crisis'. The first relates to the period of late 2008 and early 2009, the intensity of which was at its peak following the bankruptcy of Lehman Brothers in September 2008 and the subsequent nadir of global stock markets in March 2009. The second distinct period of financial crisis relates to the period of heightened perceived risk of European sovereign government default and potential exit from the Euro currency area. This period dates from late 2011 to late 2012 and had its epicentre in June/July of 2012.

The RBA data series has responded to each of these crises in the manner expected – increasing substantially. In doing so it has followed more or less the pattern of the CBASpectrum fair value estimate where both were published concurrently (although the RBA series peaked in December 2008 earlier and higher than the CBASpectrum series).

The RBA curve also behaved in a manner consistent with that of the Bloomberg and CBASpectrum curves prior to late 2008. Subsequent to the financial crisis of 2008/09 the RBA and CBASpectrum estimates fall as expected. The CBASpectrum curve was discontinued in mid-2010, but the RBA curve does respond to the European sovereign debt crisis in the expected manner – rising materially in late 2011 and the first half of 2012 before falling again.

By contrast, the spread implied by the Bloomberg fair value (BFV) curve, which we understand has recently discontinued operating, having failed to rise in the 2008/09 crisis, finally does rise when that crisis is past its worst and when the other curves are falling. The BFV spread reaches levels of around 4.5% in late 2010 and then falls modestly during the lead up to the European debt crisis but fails to rise at all in response to that crisis. This is inconsistent with expectations of how the risk premium on BBB debt would have behaved over 2012, as observed by the RBA:

*“The Bloomberg Australian dollar fair value curve appears to be overly smooth between early 2009 and late 2010. These measures did not increase as much as could be expected in early 2009, given that the global financial crisis was at its most severe at that time, and as was observed in other measures of Australian and foreign corporate bond spreads. Moreover, the Bloomberg spread measures remained elevated for an extended period of time between early 2009 and 2010, while credit spreads globally declined sharply*

*following the introduction of extraordinary policy measures; this was especially true of BBB-rated bond spreads”.<sup>3</sup>*

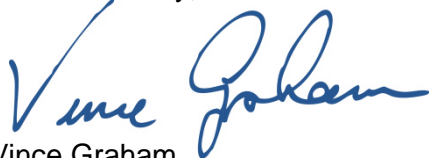
It is worth noting that even though the RBA and Bloomberg BFV estimates differ materially through much of 2008 to 2013 these differences tend to cancel each other out – with the RBA estimates being higher in some periods and the Bloomberg estimates higher in other periods. The net difference over the period January 2005 to December 2013 is only 8 basis points (0.08%) (the same comparison is not available for the BVAL curve because of its limited history).

The Bloomberg Valuation (BVAL) curve was only introduced in 2013 and has since been extended backwards in time by Bloomberg to mid-2010. As such, it does not extend to include the 2008/09 crisis. The BVAL curve is the most erratic of the three curves published over the same time period, with large single day changes in estimated yields. The behaviour of the BVAL curve is inconsistent with expectations of how the risk premium on debt would have behaved over 2012; that is, we would have expected any measured debt risk premium to rise from December 2011 to June/July 2012 – not fall. Based on the limited data set available and the erratic nature of the BVAL curve, we do not consider it to be an appropriate data set for the upcoming NSW regulatory determinations.

In summary, the NSW DNSPs consider that the RBA data series is the best third party source to estimate the allowed return on debt in energy network determinations, and is a superior measure to the BVAL or BFV for these purposes. We consider that the RBA’s recently published data series for Australian corporate bond yields provides a reliable source for estimates of the required return on debt for benchmark efficient network service providers.

If you have any queries or wish to discuss this response further please contact Mr Mike Martinson, Group Manager Regulation at Networks NSW on (02) 9249 3120 or alternatively Mr Iftekhhar Omar, Manager Group Regulatory Affairs at Networks NSW on (02) 9269 2695.

Yours sincerely,



Vince Graham  
**Chief Executive Officer**  
**Ausgrid, Endeavour Energy and Essential Energy**

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<sup>3</sup> RBA, New Measures Of Australian Corporate Credit Spreads, p.24