4 October 2010

**Lawrence Irlam**
Director
Australian Energy Regulator
GPO Box 520
Melbourne Victoria 3001

Dear Lawrence

**RE: Proposed approach to Debt Risk Premium**

Thank you for the opportunity to provide a response to the questions in your recent consultation paper on the debt risk premium. The attachment to this letter provides a response to your questions.

Yours sincerely,

Roman Domanski
**Executive Director**

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1. The AER's process

It is not clear what the AER is asking here. The introduction to this question summarises the AER's reasons for its decision, and yet the question asks for comment on the *process*.

On the process, we presume the AER is referring to the fact that it has specifically consulted on this issue. We agree that it is appropriate that the AER consults specifically on the DRP, but the reasons that the AER has cited are only part of the reason. Of much greater significance, we feel, is that the whole methodology for DRP estimation has been found to be flawed and the AER should have been consulting on how it would deal with this, rather than just an ad-hoc adjustment in response to CBA's abandonment of its benchmark and the Tribunal's ACTEWAGL decision.

2. Methodology – averaging

The AER rejected Bloomberg's fair value curves in its Draft Decision. Yet despite the rejection the AER now asserts that the average of APT and Bloomberg is better than just APT. If Bloomberg's curve is wrong then in what sense can averaging it with APT makes the outcome more right rather than more wrong? The AER's only claim for using Bloomberg is that APT is a single company not a benchmark. But averaging Bloomberg and APT does not make the resulting number any more of a benchmark, it is simply the average of a single data point and a chosen data point on a curve.

We also wish to emphasise that there is no obligation in the Rules for the AER to use Bloomberg, CBA or any other published resource. There is nothing stopping the AER from establishing its own debt cost benchmark. Indeed, this is exactly what the AER should be doing, not least on account of the many problems associated with the fair value curves published by Bloomberg, and previously published by CBA Spectrum.

With regard to the use of Bloomberg seven year fair value curves, we note the ACT's conclusion (para 72) on the use of 10 year bonds that "there seems to be little point in attempting to estimate the yield on a bond which is not commonly issued" and that (in relation to the use of fair value curves) "we do not intend to discourage the AER from investigating other ways to estimate the debt risk premium" (para 79). This is precisely the sentiment of our submission to the AER's Draft Decision, and we are frustrated that the AER has failed to address the fundamental issues, even after the ACT's adverse finding on its ActewAGL decision, and the ACT's encouragement for the AER to think more broadly about the problem.

Our further comment on both Bloomberg and APT is that these are BBB bond curves, and data points respectively. The SORI recommendation – and the AER's regulatory precedent - is to use BBB+ rated data. The AER has provided no justification for the use of BBB data. If the AER is seeking to make such a significant departure from precedent it should explain why and justify this with respect to its obligations under the Rules.

3. Data sources

We are not clear what conclusion the AER has reached on other data sources. The consultation document is silent on the data available on actual corporate debt costs for network service providers as covered in Bruce Mountain's report that was included in our submission. The consultation document provides no reason why this data has simply been ignored.

4. Other data sources

Yes, these data sources were described in Bruce Mountain's paper that was included in our submission. If the AER thinks these data of actual debt costs – which the Rules requires the AER to have regard to - are not appropriate for setting the DRP, the AER should explain why.

5. Averaging period

We disagree with the AER's approach and specific comment on the detail implementation of an element of that approach is not relevant.

6. Generating information

The answer to Question 5 applies here too.