



Submission on the *Return on debt: Choice of third party data service provider – Issues Paper*

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Australian Energy Regulator

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Introduction

Ergon Energy Corporation Limited (Ergon Energy), in its capacity as a Distribution Network Service Provider (DNSP) in Queensland, welcomes the opportunity to provide comment to the Australian Energy Regulator (AER) on its *Return on debt: Choice of third party data service provider – Issues Paper* (the Issues Paper).

In response to the AER's invitation to provide comments on the Issues Paper, Ergon Energy has focused on specific questions raised in the Issues Paper. Ergon Energy is available to discuss this submission or provide further detail regarding the issues raised, should the AER require.

Table of detailed comments

Question(s)	Ergon Energy Response
<i>Third party data service providers</i>	
1. Are there any matters, other than criteria set out in section 4, that we should consider when choosing between alternative data series to estimate the return on debt?	Ergon Energy does not propose any additional criteria for the AER to consider for choosing between alternative data series to estimate the return on debt.
2. If we use a particular series in a final decision, should we use this series for the duration of the regulatory period (as discussed in section 4.4.5)?	Ergon Energy considers the AER should apply the series chosen in its final decision for the duration of the regulatory control period. This approach would provide greater predictability and certainty for stakeholders throughout the regulatory period.
3. Which third party data service providers, other than the RBA and Bloomberg, could we consider to estimate the return on debt? a. If an alternative data service provider is proposed, what are the advantages of this provider relative to the RBA and Bloomberg series outlined in section 4?	Ergon Energy does not propose an alternate third party data service provider for the AER to consider in its estimation of the return on debt.
4. Which series provided by the RBA or Bloomberg, other than those outlined in section 4, could we consider to estimate the return on debt? a. If an alternative data series is proposed, what are the advantages of this series relative to the RBA and Bloomberg series outlined in section 4?	Ergon Energy does not propose any alternative to the RBA or Bloomberg series, other than those outlined in section 4 of the AER's Issues Paper to estimate the return on debt.
<i>Employing the Bloomberg series</i>	
5. What are the advantages and disadvantages of the BVAL series for estimating the return on debt for our benchmark efficient entity?	The main advantage of the BVAL series is that it publishes daily estimates and therefore meets the requirements outlined in the rate of return guideline for the return on debt to be estimated over an averaging period which contains a minimum of 10 consecutive business days. The BVAL estimates also reflect a broad BBB rating band which is consistent with the AER's previous decisions to use the closest approximation available where published yields do not reflect a BBB+ credit rating.

	<p>The main disadvantage of the BVAL series is that the longest published term is seven years and is therefore not consistent with the term to maturity proposed by the AER in the rate of return guideline. The AER would therefore require an extrapolation method to extrapolate the BVAL curve to a ten year term to better match the term of the benchmark efficient entity, noting that the extrapolation method proposed needs to be capable of automatically updating the return on debt estimate annually as required by the National Electricity Rules.</p>
<p><i>Employing the RBA series</i></p>	
<p>6. What are the advantages and disadvantages of the RBA series for estimating the return on debt for our benchmark efficient entity?</p>	<p>The advantages of the RBA series are:</p> <ul style="list-style-type: none"> • It would increase transparency of the AER’s Weighted Average Cost of Capital (WACC) determination process as the data the AER would use to calculate the return on debt for network service providers will be readily available through the RBA’s website and can be easily accessed by stakeholders. • The RBA series estimates credit spreads for a 10 year term consistent with the term to maturity proposed in the AER’s rate of return guideline and therefore does not require extrapolation. • The RBA series publishes month-end yield and credit margin estimates for a broad BBB rating band, which is consistent with the rating band used by the AER in its previous decisions and is the closest approximation to the benchmark credit rating of BBB+. • The RBA sample is likely to include more bonds as it includes bonds issued in both Australian and foreign currencies (US and Eurodollar bonds) and with embedded options, which may lead to more robust statistical outcomes. Having said that, Ergon Energy agrees with the AER’s comments in its Issues Paper that there may be a trade off with a larger sample size in that the sample may be an unrepresentative sample which may lead to unrepresentative results. <p>The disadvantages of the RBA series are:</p> <ul style="list-style-type: none"> • It only includes credit margin and yield estimates for the last business day of each month and therefore the AER cannot calculate a return on debt consistent with its rate of return guideline which requires each averaging period to consist of at least ten consecutive business days. • Some of the RBA’s historical Swap Risk Premium (SRP) term premium estimates are negative (i.e. the 10-year SRP is lower than the 7-year SRP –

	<p>refer July 2009 to December 2009, August 2010 and May 2011). As this type of relationship should not be observed for investment grade credit ratings, the negative SRP term premiums are likely to reflect estimation errors associated with the RBA method and raise questions regarding its accuracy.</p> <ul style="list-style-type: none"> • The effective tenor of the bonds used by the RBA to estimate the 10-year BBB yield has been consistently shorter than 10 years. • The RBA series includes bonds with embedded options and therefore adjustments to remove the impact of the option on yields may be required. <p>Overall, Ergon Energy considers that the advantages of having a publicly available credit margin series published by a creditable third party service provider such as the RBA outweigh the disadvantages. In particular, the main advantage of the RBA data is that yield estimates are available for a 10-year tenor, thereby eliminating the need for extrapolation.</p>
<p>7. The RBA series currently only publishes data on a monthly frequency. If the RBA series is used to estimate the return on debt (and daily estimates remain unavailable), state and explain your view on whether we should:</p> <ol style="list-style-type: none"> interpolate daily estimates from the RBA's month-end data (as discussed in section 5.1)? adopt an alternative approach for utilising the RBA series (as discussed in section 5.2)? 	<p>Ergon Energy considers that the interpolation method outlined in the AER's Issues Paper is a reasonable approach for calculating daily estimates of the benchmark debt yield based on the RBA's month-end estimates. However, Ergon Energy considers that the interpolation method should only apply to the credit margin component of the benchmark debt yield given the base interest rate component of the benchmark debt yield can be observed or estimated on a daily basis.</p>
<p>8. If we interpolate daily estimates from the RBA's month-end data, state and explain your view on whether we should interpolate daily estimates:</p> <ol style="list-style-type: none"> using the total yield, or the spread to either Commonwealth Government Securities (CGS) or the bank bill swap rate (as discussed in section 5.1.1)? using the number of business days or calendar days between corresponding month-end estimates (as discussed in section 5.1.2)? using some other technique (for example, non-linear interpolation)? 	<p>Ergon Energy is of the view that the AER should interpolate the daily estimates from the RBA's month end data by using the spread to either the Commonwealth Government Securities (CGS) or the bank bill swap rate rather than the total yield, as this approach would enable daily estimates of the base interest rate to be incorporated into the benchmark return on debt as CGS and swap yields can be observed or estimated on a daily basis.</p> <p>Ergon Energy's preference is to use the number of business days between corresponding month-end estimates to interpolate the daily estimates, as using calendar days will introduce additional steps to the estimation process.</p>
<p>9. In our rate of return guideline we proposed to estimate the return on debt observed over an averaging period of 10 or</p>	<p>Ergon Energy believes these issues will be considered by service providers in their regulatory proposal submissions.</p>

more consecutive business days.

As discussed in section 5.2, if we accept the use of the RBA's month-end data, what restrictions (if any) should we impose on the number of data points used?