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Ms Michelle Groves
Chief Executive Officer
Australian Energy Regulator
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Melbourne VIC 3000

By email: michelle.groves@aer.gov.au

Dear Michelle,

AER Draft Decision – Directlink Conversion to Regulated Status

This letter has been prepared on behalf of NEM transmission owners TransGrid, ElectraNet, Powerlink, SP AusNet, and Transend (the TNOs) in response to the above mentioned draft decision. It specifically addresses two aspects of that decision as follows:

1. The apparent incorrect application of CBASpectrum data to the calculation of the benchmark cost of debt; and

2. The use of the market cap (VOLL) in the calculation of the market benefits of Directlink.

Incorrect Estimate of the Cost of Debt

In recent times the use of the CBASpectrum service for estimating the risk margin on long-dated debt has come under scrutiny by at least two other energy regulators – the Economic Regulation Authority in Western Australia, and the Essential Services Commission in Victoria. Both of these regulatory bodies have confirmed earlier findings that the method used by the AER of applying data from the CBASpectrum service, without appropriate adjustments, systematically and significantly underestimates the actual yields on long-dated Australian corporate bonds. Both regulatory bodies found this considerable underestimate to be in the order of 25 basis points. More details on these decisions are set out in Attachment 1 to this letter.

As noted in Attachment 1, analysis by NERA shows that:

> *"the most appropriate adjustment to CBASpectrum estimates of yields on low rated (A and below) 10 year bonds is to add 25.6 basis points.[1]"*

[1] National Economic Research Associates, *Critique of Available Estimates of the Credit Spread on Corporate Bonds: A Report for the ENA prepared by NERA*, p 21, May 2005.

As such, and given that the draft Directlink decision assumes an "A" credit rating for the Directlink Joint Venture, the estimated risk margin on debt in the Directlink draft decision is understated by at least 25 basis points.

Market Benefits Calculation

The AER has adopted VOLL as the value for Unserved Energy (USE) in three of the six scenarios it has considered for estimating the market benefits from Directlink.

VoLL as it is defined in the Rules is NOT a measure of the value of energy to customers. The Reliability Panel has specifically made the point in its determinations that the $10,000 per MWh set by the Reliability Panel is not a measure of the value of reliability to customers. Indeed, in its discussions on the matter, the Panel members believe that the label "VoLL" is misleading, and that what the Panel is setting is a "market price cap", which balances a range of factors.

It is generally accepted (including by the AER) that VOLL does not represent an appropriate value of USE.

> *'The AER [..] acknowledges that VOLL, being the wholesale market price cap of $10 000 per MWh, does not necessarily reflect the real or true value of USE, which varies with customer type and location and the sequence in which TNSPs shed load.*[2]

It is also generally accepted that VOLL is significantly *below* the value that customers place on having a reliable electricity supply. The review of VOLL previously undertaken by NECA proposed that VOLL be increased to better reflect the value of electricity supply, and proposed an increase from the then value of $5,000/MWh to $10,000/MWh, followed by a further increase to $20,000/MWh.

The use of the market cap (VoLL) in an evaluation under the regulatory test is inappropriate.

In summary, on the basis of supporting evidence, the TNOs consider that the AER should increase the risk margin on debt in the final decision by at least 25 basis points. Furthermore, it is not appropriate to use the market cap (VoLL) in the estimated of market benefits under the regulatory test.

Should you require any further clarification on the matters raised above we would be pleased to meet with you to discuss.

Yours sincerely,

Rainer Korte

RAINER KORTE
CHAIRMAN
TNO REGULATORY MANAGERS WORKING GROUP

2 AER Draft Decision, p. 121.

Attachment 1 – Recent Reviews by Regulatory Bodies of the Use of CBASprectrum Service in Determining the Cost of Debt

1. Introduction

This document considers the recent decisions of the Economic Regulation Authority (ERA) in Western Australia, and the Essential Services Commission (ESC), and the findings of these bodies in respect of the use of the CBASpectrum service in calculating the cost of debt in regulatory decisions.

Both bodies have had occasion to closely examine the CBASpectrum outputs and have indicated in their decisions that a mark-up on the CBASpectrum estimates in the order of approximately 25 basis points is required to arrive at the fair yield of 10 year BBB+ rated corporate bonds. These decisions are discussed below.

2. Economic Regulation Authority (WA)

The ERA had cause to consider the use of the CBASpectrum as an indicator of debt margin in 2005 when considering the proposed revised access arrangements for 2005 – 2009 in respect of AlintaGas distribution systems. The ERA commented in its draft decision that:

> *"The Authority recognises, however, that this indicator [the CBASpectrum] of the debt margin should be treated with caution. Rates provided by the CBASpectrum service are not actual market observations, but rather a prediction of yields based on an econometric model, and the market observations upon which the predictions are based are very thin".*[3]

In its draft decision the ERA adopted a debt margin based on the sum of the debt margin for BBB+ bonds of 100 basis points (based largely on the CBASpectrum service) and an allowance of 12.5 basis points for debt raising costs.[4]

Between the ERA's draft decision and its final decision, the ERA had received a number of further submissions on the use of the CBASpectrum, including a report prepared by NERA on behalf of Alinta Gas Networks. The ERA then commissioned the Allen Consulting Group to provide advice on the cost of debt issue.

The NERA report concluded:

> *"The CBASpectrum estimation procedure does not determine the best fit to the available data. The CBASpectrum estimation procedure is such that CBASpectrum estimated yields <u>are expected to be, and in practice are, on average, less than actual yields for long-dated and low-rated bonds</u>. Between 30 June 2003 and 10 May 2005, actual yields on Australian bonds with more than 6 years to maturity and ratings of A or below have averaged 17.1 basis points higher than the CBASpectrum estimated yields on such bonds. For bonds with more than 8 years to maturity and ratings of A or below, the difference has averaged 22.2 basis points.*

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[3] Economic Regulation Authority, *Draft Decision for the Mid-West and South-West Gas Distribution Systems 2005 – 2009*, 28 February 2005, p 72.

[4] Ibid, p 74.

We consider that…the most appropriate adjustment to CBASpectrum estimates of yields on low rated (A and below) 10 year bonds is to add 25.6 basis points".[5]

The memo commissioned by the ERA and prepared by the Allen Consulting Group concluded:

"…the CBASpectrum service is <u>likely to underestimate the cost of 10 year BBB+ rated debt by an amount in the order of 25 basis points</u>. Accordingly, this amount should be added to the CBASpectrum predicted yields in order to obtain a statistically unbiased estimate of the fair yield of 10 year BBB+ rated corporate bonds".[6]

The memo also noted the use of alternative points of reference for the derivation of a benchmark cost of debt, such as Bloomberg and the all-up cost of issuing credit-wrapped debt.[7] In the ERA's final decision the ERA noted the recommendation of the Allen Consulting Group to the ERA that the ERA 'reconsider and increase the allowance for debt margin from that used in the Draft Decision'[8]. The ERA noted that the basis for the advice of the Allen Consulting group was the confirmation by the Allen Consulting Group of the NERA report 'that the methodology applied by CBASpectrum to predict fair yields is flawed with respect to long dated, low rated issues.[9].

In light of this advice, in its final decision the ERA adopted a debt margin range of 131 to 145.5 basis points, being 18.5 to 33 basis points higher than the debt margin of 112.5 that was set out in the draft decision.

3. Essential Services Commission (Victoria): Electricity Distribution Price Review 2006-10

In making its decision in respect of the price controls that are to apply to distribution network tariffs for the 2006-10 regulatory period, the ESC was provided with the report that was prepared by NERA[10] on behalf of the ENA and that had been submitted in respect of the proposed revised access arrangements for AlintaGas distribution systems, which was the subject of consideration by the Economic Regulation Authority of Western Australia in the first half of 2005.

In respect of the use of the CBASpectrum yields, the ESC commented:

<u>"The Commission found that the CBASpectrum yields were likely to understate bond yields by a material amount</u>. In particular, that the average understatement

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[5] National Economic Research Associates, *Critique of Available Estimates of the Credit Spread on Corporate Bonds: A Report for the ENA prepared by NERA*, p 21, May 2005.

[6] The Allen Consulting Group, *Memorandum to Peter Rixon, Economic Regulation Authority re AGN Cost of Debt Margin*, 11 July 2005, p 1.

[7] Ibid.

[8] Economic Regulation Authority, *Final Decision for the Mid-West and South-West Gas Distribution Systems 2005 – 2009*, 12 July 2005, p 223.

[9] Ibid.

[10] National Economic Research Associates, *Critique of Available Estimates of the Credit Spread on Corporate Bonds: A Report for the ENA prepared by NERA*, p 21, May 2005.

for all bonds with a remaining term of 8 to 10 years was found to be 18 basis points, and the Commission accepted that AGLE's estimate of the understatement for 10 year, BBB+ corporate bonds of 25 basis points appeared to be supported. It also found that the evidence suggested that the Bloomberg predicted yields were close to those observed in the market, overstating yields by 4 basis points on average.

In its Draft Decision, the Commission had regard to CBASpectrum and Bloomberg yields (adjusted for the biases identified above), as well as the observed yields [of] certain corporate bonds and credit wrapped bonds (with an approximate allowance for the credit wrapping premium), and concluded that a margin of 130 basis points was consistent with current market evidence (that is, with the yields averaged over the 20 days ending with 31 May 2005) for a 10 year BBB+ rated corporate bond".[11]

The ESC found that:

"…for maturities of 8 to 10 years, the average under-estimation by CBASpectrum is currently 19.9 bps (compared with 18.4 basis points in the Draft Decision), while Bloomberg's average over-estimation is 0.7 basis points (4.1 basis points in the Draft Decision). As the under-estimation for CBASpectrum would appear to rise as the term of the bond increases and its rating decreases, AGLE's estimate that the under-statement is in the order of 25 basis points for a 10 year BBB+ bond would appear to be supported by the data".[12]

The ESC drew from its analysis that in terms of the likely margin over bonds incurred on 10 year BBB+ rated debt at the end of August 2005:

- The yield of 93 basis points is predicted by the CBASpectrum service, but with a likely downward bias of 25 basis points, implying an adjusted yield for a 10 year BBB+ bond of about 118 points;

- The Bloomberg service's predicted yield of 117 basis points for a 9 year BBB+ rated bond suggests a yield of about 127 basis points for a 10 year bond (using a linear interpolation, which is likely to overstate the yield for a 10 year bond if the 'yield curve' is indeed curved);…[13]

Ultimately, the ESC adopted an estimate of the debt margin of 130 basis points.[14]

The methodology used in the CBASpectrum service of the 10 year debt margin for 'A' credit rated debt has a systematic bias, such that it produces results that are systematically significantly lower than the actual 10 year debt margin. A systematic bias means in effect that the CBASpectrum service is not actually estimating the current debt margin for 10 year debt, but is estimating a figure which is, as a matter of methodological bias, a certain number of points below that margin (which appears to be in the order of 25 points).

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[11] Essential Services Commission of Victoria, *Electricity Distribution Price Review 2006-10 - Final Decision Volume 1: Statement of Purpose and Reasons*, 19 October 2005, p 368.

[12] Ibid, p 371.

[13] Ibid.

[14] Ibid, p 372.

4. Summary

In recent times the use of the CBASpectrum service for estimating the risk margin on long-dated debt has come under scrutiny by at least two other energy regulators – the Economic Regulation Authority in Western Australia, and the Essential Services Commission in Victoria. Both of these regulatory bodies have confirmed that the method used by the AER of applying data from the CBASpectrum service, without appropriate adjustments, systematically and significantly underestimates the actual yields on long-dated Australian corporate bonds. Both regulatory bodies found this considerable underestimate to be in the order of 25 basis points.