Monday, 28 October 2013

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

rateofreturn@aer.gov.au

RESPONSE TO THE AER'S EQUITY BETA PAPER

1.1 INTRODUCTION

Spark Infrastructure made a submission to the Draft Rate of Return Guideline on 11 October 2013. In that submission we stressed the need for the AER to deliver, on the one hand, a clearly articulated framework which provides a high degree of certainty, and on the other, an outcome which allows a Network Service Provider (NSP) to effectively compete for capital in a world of virtually limitless choice for investors.

Combined with certain other elements contained in the Draft Guideline, we believe the AER's proposed reduction in beta to 0.7 will mean the regulatory regime will fail to deliver on the latter extremely important requirement. As we have previously stated, there is nothing more important to investors than certainty, and nothing more destructive to value than a lack of certainty. However a certain process which leads to an unacceptable outcome is arguably worse. We understand the Financial Investors Group's submission to the AER's Beta paper will focus on this point.

We believe that in arriving at a proposed beta of 0.7 that the AER has relied on an extremely limited data set and ignored alternative data which we believe is more relevant and more robust. In addition, the AER has selected an unnecessarily narrow definition of beta from which to begin, which over emphasises the relevance and importance of covariance between stock returns and market returns as a measure of risk. In doing so the AER has consistently chosen to anchor its views narrowly from the outset and then introduce alternative methodologies which influence only at the margin, rather than beginning with a broader perspective from which to determine an informed outcome.

Spark Infrastructure RE Limited ABN 36 114 940 984
as Responsible Entity of Spark Infrastructure Trust (ARSN 116 670 725)
Level 25, 259 George Street Sydney NSW 2000 Australia
T +61 2 9086 3600 F +61 2 9086 3666
www.sparkinfrastructure.com

1.2 SPECIFIC COMMENTS

1.2.1 Risk needs to be measured more broadly

The AER's paper on beta appears to use a single measure of risk to differentiate a NSP from the market average – the covariance between stock returns and market returns. Spark believes that this is incorrect in that it ignores a wide range of risks which are in fact considered and priced by investors. Moreover, there is also persuasive empirical evidence to establish that there is a weak relationship between return on equity and the above mentioned covariance. We refer the AER to the submissions made by the Energy Networks Association (ENA) to the Draft Guideline earlier this month and to the relevant consultation paper earlier this year.

In addition, the conceptual use of such a narrow definition for such a critical element of the Capital Assets Pricing Model is inconsistent with the broadening thrust of the National Electricity Rules as amended by the Australian Energy Markets Commission (AEMC) in 2012. Spark believes that the intention of the AEMC was to introduce a broader range of data points at every stage rather than to limit their influence by anchoring narrowly from the outset.

1.2.2 The Australian listed market provides an inadequate data set

The AER has chosen to use the Australian listed market as the primary data set despite the fact that there are currently only five listed networks. Together with four previously listed networks, this forms the benchmark entity for the AER's purposes. Spark asserts that the AER's approach relies on a clearly inadequate data set, ignores relevant and potentially useful international data - particularly from the United States, and gives undue emphasis to selected data without a clear basis. For example, in our view the AER has not provided compelling evidence as to why data from UK water assets should be accorded more weight than data from US energy stocks. Spark supports the arguments on this topic outlined by the ENA in its recent submissions and refers the AER to the detailed arguments contained therein.

1.2.3 The AER's currently stated principles and parameters will not deliver an adequate return

The combination of parameters as currently proposed by the AER is unlikely to deliver a globally competitive return on equity. Calculation of the rate of return remains wedded to the prevailing risk free rate as determined by the 10 year Commonwealth bond rate and a figure for beta which the AER is now proposing should be 0.7. Moreover, the AER has left only the MRP open to determination at each reset (this is in itself problematic in relation to providing certainty to investors) but has stated that it will rely on historical excess returns, surveys and other historical information – none of which is likely to provide a market risk premium in excess of 6.0%.

Based on this simple assessment it is clear that unless there is movement between the draft and final rate of return guideline, and if the guidelines are applied at the next regulatory resets, then returns will be significantly lower for a NSP than in the prior regulatory periods. However, from a risk perspective, what has actually changed over that period to justify lower rates of return? We contend that little has changed positively to justify lower returns and yet the AER has reduced beta from 1.0 to 0.8 historically, and now is looking to further reduce beta to 0.7.

Spark has consistently argued that the process must have credible commercial and practical overlay to ensure the rate of return provides both a competitive and predictable return to long term owners of network assets. If not, the National Electricity and Gas objectives will not be met, and efficient investment in energy network assets will not occur to the long-term detriment of consumers.

Spark was delighted to host a lunch for some of its key investors on 22 October 2013 which was attended by Mr Andrew Reeves, Chairman of the AER. These investors included both specialist infrastructure investors with global perspectives and Australian superannuation funds. It is pertinent to provide some of those comments here in the context of investor's expectations around certainty and eventual returns**:**

> "I don't have the confidence that I used to (in the Australian regulatory environment). Australia has become more politicised and the environment is more opaque. I have already seen capital flowing away." **Jonathan Reyes – AMP Capital**
>
> "While regulation has changed, for example in the United Kingdom, markets have maintained their high standards and expectations over time. It is terrible that regulated returns are so strongly linked to bond rates." **David Maywald – RARE Infrastructure**
>
> "While the AER has provided a number of parameters and commentary in its draft guideline, it is still not clear to investors how the AER will actually use its discretion to calculate regulated returns." **Ben McVicar – Magellan**
>
> "We take a global view of potential investments and undertake benchmarking of regulatory regimes around the world. To actually attract capital to these assets the Australian regulatory environment needs to be in the top quartile of regulatory regimes (in relation to returns)." **Tim Humphries – AMP Capital**

In conclusion, Spark opposes a change in the figure for beta from the existing 0.8 to the AER's proposed 0.7. In combination with the suite of parameters currently proposed by the AER this will lead to an unjustified erosion of returns which does not reflect the actual risks faced by NSP's. Australian regulated infrastructure assets must compete for capital in a global market place where investors have a world of choice. If returns are not acceptable, then we will quickly see capital transferred elsewhere, which we have already seen recently on our share register.

If you have any questions or would like to discuss this submission further please contact Mario Falchoni, General Manager of Investor Relations and Corporate Affairs on 02 9086 3607.

Yours faithfully,

Rick Francis
Managing Director