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SUBMISSION ON THE AER'S DRAFT DECISIONS FOR NSW ELECTRICITY DISTRIBUTORS

1.1 EXECUTIVE SUMMARY

Spark Infrastructure is disappointed with the Australian Energy Regulator's (AER) continued adherence to the principles and methodologies established in its Rate of Return Guideline published in 2013, and specifically with the equity returns which have resulted from this and are now being proposed in the Draft decisions for Ausgrid, Endeavour Energy and Essential Energy.

The past twelve months have seen bond rates continue to contract, resulting in the prospect of ever diminishing regulated equity returns. This is occurring in a business environment which is delivering increased risks to Network Service Provider's (NSPs) through changing technologies, changing customer expectations and behaviours, an uncertain economic climate and a range of other regulatory and public policy changes. These developments have confirmed the validity of Spark Infrastructure's objections expressed at the time of the review process and have exposed the error of the AER's approach.

Spark Infrastructure urges the AER to fundamentally reconsider its devotion to the mechanistic application of the Sharp-Lintner CAPM, and in particular its reliance on bond yields as a proxy for the risk free rate. This methodology has proven itself incapable of delivering a return on equity which reflects the requirements of long term investors. To do otherwise will lead to reduced investment in the renewal of electricity infrastructure and the associated negative impacts on services to consumers of electricity.

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1.2 INTRODUCTION

Spark Infrastructure is an ASX listed investment fund with a 49% interest in three electricity distribution networks; SA Power Networks based in South Australia; and CitiPower and Powercor (together known as Victoria Power Networks) based in Victoria. Our securityholders consist of a range of specialist infrastructure investors and fund managers, superannuation funds and retail and private investors, including a growing number of self-managed superannuation funds. Our most recent register analysis show that Spark Infrastructure is around 74% Australian owned.

We would like to take the opportunity provided by AER's call for submissions on its Draft Decisions for Ausgrid, Endeavour Energy and Essential Energy to make certain comments in relation to rate of return matters and more specifically, on the AER's proposed return on equity. This submission does not make any comment on any other matters contained in those Draft Decisions.

While Spark Infrastructure has no direct interest in the NSW based electricity distribution businesses which are the subject of the relevant Draft Decisions, it is clear that the AER's deliberations and eventual decisions for these Network Service Providers (NSPs) will have important flow on effects to all NSPs regulated by the AER.

1.3 OUR POSITION HAS BEEN CONSISTENT AND REMAINS UNCHANGED

Spark Infrastructure engaged with the AER throughout its "Better Regulation" consultation process on a range of matters including the rate of return. We contributed to the Financial Investors Group (FIG) submission to the AER Consultation Paper: Rate of Return Guideline lodged in June 2013, and were represented at a number of meetings and forums hosted by the AER as part of its regulatory review process. We made a submission to the Draft Rate of Return Guideline in October 2013 and following that on the AER's Equity Beta paper, later that month.

In those submissions we stressed the need for the AER to deliver both a clearly articulated framework providing a high degree of certainty, and an outcome which allows NSPs to effectively compete for capital in a world of virtually limitless choice for investors. Our arguments throughout the review process, which we have not wavered from, can be summarised as follows:

1. The AER should embrace increased discretion and apply this in a commercial manner. The desirability of this policy direction was clear from the rule change effected by the Australian Energy Markets Commission (AEMC) in December 2012. Despite this, the AER has demonstrated a remarkable degree of risk aversion and has gravitated back towards its well-trodden prescriptive paths.
2. Getting the right outcome is more important than establishing a comfortable theoretical construct. There is little point in creating a methodology which is transparent, repeatable and predictable if its outputs do not serve to attract investment, and thus ensure the delivery of an essential service, in the real world.

3. The methodology used by the AER for calculating returns is fundamentally flawed. The exclusive use of the Sharp-Lintner CAPM should be eliminated, given its inherent biases, its mechanistic reliance on narrow and questionable input data and its failure to deliver a commercially attractive and market competitive rate of return. The idea that the Sharp-Lintner CAPM can deliver the right outcome as long as its inputs are correctly estimated was rejected by the AEMC in its rule change of December 2012 which expressly requires the AER to give consideration to other models. In our view the AER has not done so in any meaningful way and continues to rely almost exclusively in the Sharp-Lintner CAPM.

4. The link between bond rates and the return on equity should be eliminated. Bonds rates can be extremely volatile and operate within a very broad range. Long term infrastructure investors typically have stable expectations about returns and do not structure their investment decisions around merely securing a premium over the risk free rate. There is no indication that the fall in bond rates has reduced the equity return expectations of investors in any other sector of the economy. As a result, the bond yield related reduction in regulated returns is placing regulated infrastructure investments at a substantial disadvantage when sourcing investor funds.

5. 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. This is particularly true in relation to the estimate of the equity beta, and returns us to the inadequacy of the Sharp-Lintner CAPM.

1.4 RECENT DEVELOPMENTS HAVE CONFIRMED OUR VIEW

We have consistently argued that the combination of parameters proposed by the AER was unlikely to deliver a globally competitive return on equity. This is in fact what we are now seeing. The passage of time has turned this expectation into reality and served to underscore the error in the AER approach.

The risk free rate has fallen from around 4% at around the time the AER delivered its Final Rate of Return Guideline at the end of 2013 to around 2.5% in February 2015. This is around 340 basis points below the level which prevailed at the time of SA Power Networks regulatory reset in 2010. This is an enormous change which bears no correlation to the underlying risk within these businesses.

The business environment is changing rapidly and fundamentally and this is challenging the perceived low-risk nature of our industry. Customers are becoming more considered about how much energy they use and when. Smart meter technology is available and functional, and following the Victorian example will continue to spread even with the adoption of opt-in approaches.

Technology, particularly in relation to solar generation and energy storage, continues to develop and will aid the spread of distributed generation over time. As more people make use of these technologies the cost for those who do nothing will rise, thereby increasing the incentive to switch and accelerating the rate of change. As the volume of electricity usage declines, the cost of gearing infrastructure for peak usage becomes increasingly expensive and challenging. At the same time, the adoption of new technologies by those who can afford them adds to the burden of those who cannot, thereby increasing social inequity.

Poorly conceived government policy, for example around PV feed-in tariffs, is accentuating the issue and potentially driving incorrect investment decisions for the longer term.

So, at the same time as the risks associated with the provision of network services are increasing, the AER's methodology is having the effect of reducing equity returns. This makes no sense at all.

1.5 THE PERSPECTIVE OF OUR INVESTORS

Spark Infrastructure enjoys a very stable register populated with a number of large specialist infrastructure investors with long term investment horizons. This is consistent with the type of assets in the Spark Infrastructure portfolio and our approach to their long term stewardship. Some have been on Spark Infrastructure's register since 2006, at around the time the company initially listed on the ASX. We have long term relationships with these investors and we place a great emphasis on understanding the needs and priorities of our securityholders.

The feedback which they are providing to us is that the returns contained in the AER's draft decisions for the NSW NSPs, and by extension the returns which can be expected for SA Power Networks and CitiPower and Powercor under the existing methodology are not adequate to maintain current levels of investment.

We have consistently argued that the process used to determine equity returns must have a credible commercial and practical overlay to ensure it provides both a competitive and predictable return to long term owners of network assets. If not, the National Electricity objectives will not be met, and efficient investment in energy network assets will not occur to the long-term detriment of consumers. At the current expected levels of return on equity, investors will reduce their commitment to the sector.

Long term infrastructure investors think in terms of absolute returns, as opposed to a fixed margin over a risk free rate. As we have seen, the latter can rise and fall markedly over time. There is ample evidence that long term infrastructure investor's expectations of equity returns remain relatively constant over time. In contrast, short term investors often benchmark their returns off a variety of factors which can rise and fall quickly. Short term investors do play an important part in the market and do provide liquidity to listed companies, however there can be no certainty that these short-term investors will be there when the capital investment is required, and hence the true test should be of long-term infrastructure investor's return expectations.

Australian regulated infrastructure assets must compete for capital in a global market place where investors have a virtually limitless investment universe. If returns are not competitive in one sector then capital is very easily transferred elsewhere.

The comments reproduced below were provided to Spark Infrastructure in 2013 and were included in our submission to the AER's Equity beta discussion paper in October of that year. The sentiments behind them have not changed and are even more striking in today's environment:

"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**

“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**

1.6 CONCLUSION

Spark has consistently argued that the process used to set regulatory returns must have a credible commercial and practical overlay to ensure it 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.

The current round of regulatory resets, including those for Ausgrid, Endeavour Energy and Essential Energy; as well as the approaching resets for SA Power Networks, CitiPower and Powercor represent a critical time in the minds of investors. We are on the cusp of a significant re-appraisal and potential re-allocation of capital.

Spark Infrastructure urges the AER to fundamentally reconsider its devotion to the mechanistic application of the Sharp-Lintner CAPM, and in particular to its reliance on bond yields as a proxy for the risk free rate. This methodology has proven itself incapable of delivering a return on equity which reflects the requirements of long term investors.

We understand that we are asking for a radical departure from the current practice. However we have no doubt that is precisely what is required.

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,

A handwritten signature in black ink, appearing to read 'Rick Francis', written in a cursive style.

Rick Francis
Managing Director