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RESPONSE TO THE AER'S DRAFT RATE OF RETURN GUIDELINE

1.1 INTRODUCTION

Spark Infrastructure (Spark) is an ASX listed investment fund with a 49% interest in three electricity distribution networks; CitiPower and Powercor (together known as Victoria Power Networks) based in Victoria, and SA Power Networks based in South Australia.

Spark contributed to the Financial Investors Group (FIG) submission to the AER Consultation Paper: Rate of Return (RoR) Guideline lodged in June 2013, and has been represented at a number of meetings and forums hosted by the AER as part of its regulatory review process in the past 12 months.

We commend the AER for the transparency of the various review processes and for its demonstrated willingness to engage on the various arguments which have been put forward by network service providers and financial investors such as ourselves. We also believe the thoroughness of the process has been appreciated by the investment community as a whole.

Overall the proposed guidelines represent a positive move forward and the RoR Guideline is the most important new guideline in our view. It certainly has the greatest potential impact on our investments and has come about in a period of sustained market uncertainty and volatility.

There is nothing more important to investors than certainty, and nothing more destructive to value than a lack of certainty. In this context Spark believes that the Final RoR Guideline, which is due in December, ought to provide enough clarity for an investor to form a reasonable view of likely returns prior to a given regulatory reset taking place.

While we expect substantial alignment with the material provided by Network Service Providers, their peak bodies and other financial investors, this submission represents the views of Spark only. Our position is based on an intimate understanding of the assets in our portfolio as well as of the priorities and inclinations of the many fund managers, superannuation funds and retail investors whom have chosen to invest in CitiPower and Powercor and SA Power Networks via Spark.

1.2 IMPORTANT PRINCIPLES

1.2.1 The use of commercially appropriate discretion is important

Spark supports the policy intent contained in the AEMC's rule change determination of 2012, specifically, the granting of additional discretion to the AER in the determination of returns. It is important that the AER firstly embraces the discretion it has been granted by the revised rules, and secondly, that it then uses this in a commercial manner which maintains the competitiveness and attractiveness of regulated utilities as an investment class, for the long term benefit of consumers.

1.2.2 Getting the 'right' outcome is paramount

Spark acknowledges the challenges faced by the AER in delivering a rate of return methodology which, on the one hand is explainable, repeatable, transparent and predictable; and on the other hand which delivers a commercially viable rate of return and thus ensures efficient investment in the asset base (to deliver efficient and effective services and maintain reliability) in the long term interests of consumers. Therefore, while theoretical constructs are a necessary means to an end, it is the final determined rate of return which has real world impacts and which must therefore receive priority. Accordingly, the process must have credible overlay at the conclusion to ensure the rate of return provides both a competitive and predictable return to long term owners of regulated network assets.

1.2.3 Providing certainty is also important

Spark appreciates the need to conduct a thorough review process and is comforted by the AER's comments that this is being done with a view to avoiding further unnecessary tinkering in the future. However, financial markets are extremely sensitive to uncertainty. The AER ought to focus on matters which are universally recognised as requiring discussion and debate to reach a long term view which is capable of securing broad acceptance. In particular, the attempt to revisit gamma once again, given the matter has been settled on appeal, is in our view unnecessary and damaging. It presents an image of regulatory volatility and increases the perception of regulatory risk. The Australian Competition Tribunal's (ACT) decision on this matter was reached after extensive analysis and should be allowed to stand.

1.2.4 A benchmark approach is appropriate and necessary

Spark supports the AER's affirmation of a benchmark approach to regulation, and also certain specific parameters contained in the Draft Guideline. In particular, we believe the continued use of the 10 year commonwealth bond rate as the proxy for the risk free rate, and the assumption that investment is funded using 60% debt and 40% equity are appropriate. More generally, Spark also supports the enhanced use of incentive based regulation which is a characteristic of the various guidelines which together form the AER's Better Regulation Program.

1.2.5 Further consolidation of regulation deserves serious investigation

Spark has long viewed the consolidation of regulation away from the States and towards one national regulator (i.e. the AER) as positive. In particular, while we acknowledge the geographic difference between the East Coast Grid and the infrastructure of Western Australia, we see no distinction between the capital markets available to investors in the respective assets. The existence of separate regulatory regimes, each applying distinct approaches and methodologies and therefore producing contrasting outcomes, only serves to increase the level of uncertainty for all investors. We urge the AER and policy makers to extend its regulatory jurisdiction to include relevant businesses in Western Australia.

1.3 SPECIFIC RECOMMENDATIONS

1.3.1 Cost of debt

Position

- Spark supports the proposed move to a trailing average for the calculation of the cost of debt
- The trailing average should be calculated over 10 years rather than 7 years to better reflect the longevity of the underlying assets and efficient financing practice
- The rating assumption should be set at BBB (using the Standard & Poor's rating criteria)

Commentary

Spark believes that the use of a 10 year trailing average would provide additional certainty and predictability to investors and would therefore be preferable to a 7 year timeframe. The 7 year term for the cost of debt does not reflect actual current efficient financing and a reduction in the term to 7 years will increase refinancing risk that is not being compensated for elsewhere. A longer timeframe better reflects the actual tenors of debt refinancing, enables refinancing risk of existing portfolios to be spread over 10 years thus reducing concentration risk and better matches the long-life nature of the underlying assets.

Market evidence does not support more than a BBB rating. The recent tightening by credit rating agencies provides an independent assessment of the state of the industry and confirms that the risk profile has changed for the negative. Actual risk assessment around gearing levels should be at the discretion and risk of the businesses given they are best placed to make judgements on the matter.

1.3.2 Cost of equity

Position

- Spark urges a conceptual shift away from the view that investors require a fixed return over the risk free rate. Long term infrastructure investors think in terms of absolute returns. Investor's expectations around total equity returns do not fall because bond rates have fallen
- We urge a move away from the rigid application of the Sharpe-Lintner CAPM (SL-CAPM) and the AER's current focus on this methodology as the 'Foundation model'
- We support the use of the SL-CAPM as one methodology in a multi-model approach which includes the Fama-French Model in addition to the Black CAPM and the Dividend Growth Model which have already been partially accepted by the AER
- We also do not support the use of the SL-CAPM to establish a 'range', rather it should be used to determine a point estimate only
- We support the continued use of the 10 year Commonwealth bond rate as the proxy for the risk free rate (RFR) and the 60% debt/40% equity funding assumption which currently exists
- While the AER's position in relation to potential changes to the current assumed Beta is not yet available, Spark cautions against any radical departure from the present level given the limitations posed by the small size of the Utilities sector and the Australian market and the impact of company specific activity on Beta.

Commentary

While the prescriptive application of the SL-CAPM has worked relatively well in the past, we have seen that in a period of unusually low bond rates in the wake of the Global Financial Crisis (GFC), that the current methodology can produce outcomes which are both counter-intuitive and commercially unacceptable. The sharp fall in bond rates flowing through the SL-CAPM via the risk free rate has reduced regulatory resets to a 'lucky dip' based on the timing of regulatory periods.

The Rate of Return objective as stated in the National Electricity Rules is that *"the rate of return for a service provider is commensurate with the efficient financing costs of a benchmark efficient entity with a similar degree of risk as that which applies to the service provider."* To meet this, regard must be had to the prevailing conditions in the market for equity funds. Of more recent times we have seen the RFR move down, and the AER's rigid use of the SL-CAPM model result in Return on Equity (ROE) of around 8% which is at odds with market demands for a competitive ROE.

The majority of the Draft RoR Guideline is centred on SL-CAPM as the foundation model and the use of input ranges and point estimates, with the final step (albeit the selection of a 'point estimate' in the range) requiring the use of regulatory judgement. While this is procedurally coherent, the overall test must be that the final outcome makes sense commercially; otherwise there will be a disincentive to provide capital to service providers – which will not achieve the national electricity and gas objectives. If the SL-CAPM is indeed to be used in an informative rather than a deterministic manner, then the concept of a foundation model is not appropriate.

To assist in achieving commercial returns, Spark urges a move away from an application of the SL-CAPM model with a prevailing risk free rate and fixed Market Risk Premium (MRP) in the calculation

of allowed returns. This is not without precedent. IPART, in its conclusions to its recent review of the method for determining the Weighted Average Cost of Capital (WACC) in NSW, has established a path for this by adopting equal weighting for calculation of the MRP and RFR using both short term and long term averages. This is based on the stated acknowledgment that the relationship between the MRP and RFR is not constant, and that the traditional methods are currently delivering WACCs that are too low. It also highlighted the importance of being internally consistent in using short and long term averages for the various input parameters.

This is only one approach but it reflects the kind of pragmatic flexibility which we believe is required. We also note the proposed use of a multi model system as previously submitted by the Energy Networks Association and the FIG, and refer you to those documents for further detail on how this could work. The models contained therein – the SL-CAPM, Black CAPM, Dividend Growth Model and Fama-French model are familiar to the AER, and with the exception of Fama-French are already contained in the draft guideline.

The key element here is that the application of the SL-CAPM should not give rise to a range, but rather, should be used to determine a point estimate only. We point out that the AER has stated that it would be prepared to review the use of a foundation model altogether if the other methodologies point to a level outside of that range. However, the elimination of a range from the outset would provide the necessary flexibility while removing the possibility of potentially messy re-work, and the associated uncertainty, at a later point. It would also give greater weight to the other methodologies, which we believe is an important and necessary change to the Draft RoR Guideline.

The relative capital efficiency of the various Network Service Providers is relevant in the context of this discussion. Spark notes the 2012 AMP Capital submission to the Productivity Commission called “The Capital Efficiency of Australian Electricity Distributors” dated November 2012. That report sought to demonstrate that the capital efficiency of privatised electricity distributors at least matched their UK counterparts. It also highlighted that the capital efficiency of state owned businesses was far worse, indicating that they had a real incentive to over-invest which does not apply to privately owned businesses.

It cannot be overemphasised that 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. They do not rise or fall merely because bond rates rise or fall. In contrast, short term investors often benchmark their returns off a variety of factors which can rise and fall quickly. 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 world of choice. If returns are not acceptable, then we will quickly see capital transferred elsewhere. This would be very bad news for asset renewal and the future reliability of network infrastructure in this country.

1.3.3 Beta

Spark will reserve any detailed commentary on beta until the release of the AER's work on this topic. However, it is appropriate to issue a note of caution in advance of its publication. We believe that any assessment of beta will be limited by empirical issues and sample size. The Utilities sector is small, for example, relative to mining stocks, and this tends to understate the true equity beta applicable to such businesses. In addition, Australia is a more volatile market than say the USA given its sector concentration which again understates the true equity beta. Moreover, Spark asserts that specific corporate activity has had a bigger influence on beta than any theoretical relationship.

1.3.4 Valuation of imputation credits (Gamma)

Position

- Spark supports the maintenance of gamma at the level of 0.25 as determined by the Australian Competition Tribunal in 2011

Commentary

Spark has listened carefully to the AER's stated reasons for revisiting the level of gamma and proposing its increase from the current level of 0.25 to 0.5, however, we continue to see no valid reason to reopen the matter. In our view gamma at 0.25 reflects the most up-to-date and robust empirical evidence.

Moreover, we are of the view that the level of gamma has been settled by the ACT after exhaustive analysis in its decision of 2011. The ACT presented strong evidence in support of its decision at the time which we believe continues to be applicable today after taking into account current data.

Moreover, the proposed move to 0.5 appears excessive in its quantum as well as erroneous in its reasoning. This is relevant in the context of promoting certainty in the investment community by reaching a commercially workable outcome.

Spark appreciates the opportunity to provide its input on this important matter. 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
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