

11 May 2007

Mr Steve Edwell  
Chairman  
Australian Energy Regulator  
GPO Box 520  
Melbourne VIC 3001

**EnergyAustralia™**

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*Steel*

Dear Mr Edwell

**George Maltabarow**  
Managing Director

**Request for revocation of EnergyAustralia's pricing cap decision**

I refer to your letter dated 17 April 2007, which was received on 24 April 2007.

Energy Australia wrote to the AER on 14 March 2007 requesting that the revenue cap be revoked under clause 6.2.4(d)(2) of the National Electricity Rules based on a material procedural error and reserving its position with respect to other grounds upon which the revenue cap could be revoked and substituted by the AER.

Your response stated that the AER was of the view that there are no grounds under the National Electricity Rules to reopen EnergyAustralia's revenue cap. In particular, the material procedural error in setting TransGrid's revenue did not extend to the process for setting EnergyAustralia's revenue cap.

Further, your response did not address the points made by EnergyAustralia in its initial request. In the absence of any clarification concerning those reasons, EnergyAustralia remains of the view that the revenue cap should be revoked and substituted. The purpose of this letter is to request the AER to revoke and substitute the revenue cap pursuant to clause 6.2.4(d), which confers jurisdiction where it appears to the AER that:

- (1) the revenue cap was set on the basis of false or materially misleading information provided to the ACCC (clause 6.2.4(d)(1)); and
- (2) there was a material substantive or procedural error in the setting of the revenue cap and the prior written consent of the parties affected by any proposed reopening of the revenue cap has been obtained by the ACCC (clause 6.2.4(d)(2)).

**1 Request**

On behalf of EnergyAustralia, I request that the AER revoke and substitute EnergyAustralia's revenue cap for the period 2004-05 to 2008-09, on the following bases:

- 1 the CBASpectrum data provided to the ACCC was false or materially misleading for the purpose to which it was put because the estimates did not represent accurate estimates of actual yields on long-dated, low-rated corporate bonds (clause 6.2.4(d)(1) Code);
- 2 the ACCC made a material substantive error, by using unadjusted CBASpectrum data despite having received, contemporaneously with its consideration of EnergyAustralia's revenue cap application, information demonstrating that CBASpectrum methodology resulted in a downward bias and was not a measure of the cost of debt as required by the Code (clause 6.2.4(d)(2) Code); and
- 3 the ACCC made a material procedural error, in failing to take into account a relevant consideration, being information demonstrating that CBASpectrum data understated the debt margin and therefore the cost of debt (clause 6.2.4(d)(2) Code).

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Partner

## 2 Statutory framework

As you are aware, as part of the revenue cap decision, the ACCC was required to adopt a cost of debt which is “estimated with reference to current prices in domestic and overseas corporate debt markets” taking into account the maturity and duration characteristics of the network owner’s portfolio and the associated current market yields. Current market yields should fully reflect the network owner’s credit risk.

The method used by the ACCC to establish the cost of debt was to establish:

- 1 a risk free cost of debt; plus
- 2 an estimate of the margin for the risk of an ‘A’ credit rated enterprise.

In respect of 1, the ACCC used the market price for 10 year Commonwealth bonds and, in respect of 2, it relied solely upon CBASpectrum data.

Although the term “estimate” entails an approximate judgment which may diverge from the final figure being estimated, the process of estimation aims at ascertaining as accurate an approximation as is possible in the circumstances. Implicit in this process is the fact that an estimation methodology should produce a figure that is capable of being either an overstatement or an understatement of the correct figure. A *necessary* bias towards either conclusion would undermine the accuracy of the estimation methodology and the ultimate estimate it yields.

In the case of the cost of debt, the figure to be estimated is the actual cost of debt in current prices, or alternatively current yields. It is not a forecast.

## 3 False or materially misleading

On 23 September 2003, EnergyAustralia submitted to the ACCC its application in relation to the reset of EnergyAustralia’s revenue cap for the second regulatory period commencing 1 July 2004.

It attached a report by NEEG on the Weighted Average Cost of Capital (WACC) for EnergyAustralia. The report stated that:

As of 1 September 2003, CBASpectrum estimate that the margin over the risk free rate of a 10-year bond issue of rating ‘BBB+’ based on a 10 day average consistent with the risk free rate is 99 basis points.<sup>1</sup>

Implicit in that statement is the proposition that the figure is an unbiased estimate suitable for use under the Code.

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<sup>1</sup> NEEG, *Weighted Average Cost of Capital for EnergyAustralia: Submission to the ACCC by NEEG*, September 2003, p30.

The Commonwealth Bank of Australia (CBA) has, over time, described its CBASpectrum service as enabling users to:

- view both the pricing history of traded securities and fair-value curves;
- plot both security values and fair-value curves for a specific date;
- perform relative-value analysis on multiple securities;
- download research on corporate issuers and general debt market events; and
- conduct statistical analysis on security values.

EnergyAustralia is not aware whether it is anywhere made explicit in the material provided by CBA that the CBASpectrum methodology supplements actual data with 'phantom data' that affects the output generated, by lowering the apparent yields on long-dated bonds.

A report prepared by NERA for the Electricity Networks Association (attached) reviewed the methodology employed by CBASpectrum in estimating yields on corporate debt. It plotted yield curves based on the best fit of actual data and compared it to the CBASpectrum data.

NERA notes that CBASpectrum used phantom observations based on the credit spread predicted for the next highest rated bond of ten years. As a result, NERA found that, "the two curves begin to materially depart for longer dated maturities".<sup>2</sup> That is, NERA found that the CBASpectrum data materially departs from reality. Accordingly, the CBASpectrum data is a false or materially misleading representation of actual yields for long-dated corporate bonds.

In its final decision setting EnergyAustralia's revenue cap, the ACCC stated:

For this decision, the ACCC considers it is appropriate to reference the debt margin to the CBASpectrum benchmark which estimates a fair yield curve (of various terms and credit ratings) for Australian corporate bonds.<sup>3</sup>

The ACCC used unadjusted CBASpectrum data to estimate the debt margin in EnergyAustralia's revenue cap decision.

Based on the material referred to above, it is apparent, and should appear to the AER, that the revenue cap for 2004-05 to 2008-09 was set on the basis of false or materially misleading information provided to the ACCC in each of the following respects:

- the identification of an unadjusted and biased estimated yield was of itself false or materially misleading;
- the descriptive material made available by the CBA accompanying the curve was false or materially misleading; and
- the descriptive material in EnergyAustralia's initial submission was false or materially misleading.

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<sup>2</sup> Grundy B, Hird T, *Critique of available estimates of the credit spread on corporate bonds*, A report prepared for the ENA, May 2005, p6.

<sup>3</sup> Australian Competition and Consumer Commission, *NSW and ACT transmission network revenue cap Energy Australia 2004-05 to 2008-09*, Final decision, 27 April 2005, p80.

#### **4 Substantive error**

The ACCC conducted the EnergyAustralia decision in parallel with the TransGrid decision. TransGrid made confidential submissions to the ACCC to the effect that the methodology used in the CBASpectrum service for estimating the 10 year debt margin has a systematic bias, producing results that are systematically significantly lower than the actual 10 year debt margin. The presence of a systematic bias in the data entails that the CBASpectrum data does not estimate the current debt margin for 10 year debt, but instead estimates a figure which is, due to a methodological bias, a certain number of points below that margin.

In light of the circumstances set out above, it is our view that there was a material substantive error in the setting of the revenue cap, in so far as the revenue cap was based on an incorrect estimate of current (as at the time of the estimate) prices of debt or, alternatively, current market yields. The error occurred because the ACCC did not use other accurate estimates of current market yields and did not otherwise correct the CBASpectrum data for the systematic bias in its estimate.

In support of our view, we refer to the attached report prepared by NERA for the Electricity Networks Association.

We also note that subsequent regulatory decisions by the AER and other Australian and international regulators have either used another service, such as the Bloomberg service, to estimate the debt margin or adjusted the CBASpectrum data by using a correction factor.<sup>4</sup>

As set out in section 3 of this letter, the ACCC relied on the unadjusted CBASpectrum data in calculating the debt margin and cost of debt. It is therefore apparent, and should appear to the AER, that there was a material substantive error in the setting of EnergyAustralia's revenue cap.

#### **5 Procedural error**

EnergyAustralia's letter to the AER of 14 March 2007 details a procedural error in the setting of the revenue cap, in that the ACCC failed to take into account a relevant consideration, that being information received contemporaneously with its consideration of EnergyAustralia's revenue cap application, which demonstrated that the CBASpectrum service used a flawed methodology that resulted in estimated yields that were less than actual yields for long-dated, low-rated bonds.

EnergyAustralia repeats the matters set out in that letter in support of the request in this letter. On the basis of those matters, it is apparent, and should appear to the AER, that there was a material procedural error in the setting of EnergyAustralia's revenue cap.

#### **6 Timing of response**

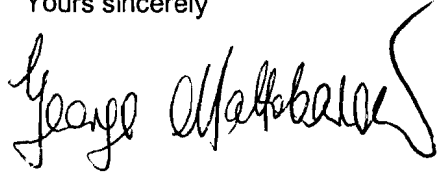
I would appreciate a response by midday Friday, 18 May 2007.

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<sup>4</sup> Economic Regulation Authority, *Proposed Revisions to the Access Arrangement for the Mid-West and South-West Gas Distribution Systems*, Final Decision, 12 July 2005; Australian Energy Regulator, *Directlink Joint Venturers' Application for Conversion and Revenue Cap*, Decision, 3 March 2006; Australian Energy Regulator, *Powerlink Queensland transmission network revenue cap 2007-08 to 2011-12*, Decision, 8 December 2006.

In the event that EnergyAustralia has not received a response by this date, it reserves the right to pursue other avenues to redress the errors in the ACCC's 2005 decision and the AER's failure to revoke, without further notification to the AER.

Yours sincerely

A handwritten signature in black ink, appearing to read "George Maltabarow". The signature is written in a cursive style with a large, sweeping flourish at the end.

**GEORGE MALTABAROW**  
*Managing Director*