7 January 2011

Alinta Sales Pty Ltd
ABN 92 089 531 984
12-14 The Esplanade
Perth WA 6000
PO Box 8348
Perth BC WA 6849
T 08 9486 3000
F 08 9221 9128
www.alinta.net.au

Dr Duc Vo
Senior Analyst
Discussion Paper: Measuring the Debt Risk Premium: A Bond-Yield Approach
Economic Regulation Authority
PO Box 8469
Perth Business Centre
PERTH WA 6849

By email: publicsubmissions@erawa.com.au

Dear Dr Vo

MEASURING THE DEBT RISK PREMIUM: A BOND-YIELD APPROACH

Alinta Sales Pty Ltd (Alinta) appreciates the opportunity to comment on the discussion paper released by the Economic Regulation Authority (Authority) regarding a proposed change to the method used to derive an estimate of the debt risk premium (DRP).

Alinta understands that a change in the method used to derive an estimate of the DRP may be warranted given the cessation of published data that has historically been relied on to provide market evidence of a DRP that is "*...commensurate with prevailing conditions in the market for funds and the risks involved in providing reference services.*"

In the attached submission, Alinta has commented only on certain issues arising from the Authority's proposed method, and the absence of a comment on any specific issue should not be taken to indicate that Alinta supports, or does not support, that particular aspect of the Authority's proposed method.

Should the Authority wish to discuss any of the issues raised in the attached submission, or require further information, I can be contacted on 9486 3749.

Yours Sincerely

Corey Dykstra
Manager, Regulatory Affairs
Alinta Sales Pty Ltd

Att.

ATTACHMENT A

MEASURING THE DEBT RISK PREMIUM: A BOND-YIELD APPROACH

Background

As indicated in the Economic Regulation Authority's (Authority) Discussion Paper, economic regulators in Australia have historically relied on estimates of 10-year fair yield curves published by Bloomberg and/or CBA Spectrum to derive estimates of the debt risk premium (DRP).

It is understood that CBASpectrum ceased publishing its estimates of fair yield curves across all credit ratings for Australian corporate bonds in September 2010, while the duration of Bloomberg's fair yield curves are now well below the 10-yer period traditionally used by Australian regulators.

Issue

The Authority's Discussion Paper notes that, prior to the Global Financial Crisis, which started in 2008, Bloomberg's estimate of the fair yield curve for 10-year BBB Australian corporate bonds was 'consistent' with observed yields for Australian corporate bonds (of the same rating) trading.

The Authority observes that Bloomberg's recent estimates of the 7-year BBB fair yield curve are 'substantially different' from observed Australian corporate bond yields. Figure 2 in the Authority's Discussion Paper suggests that Bloomberg's estimate of the 7-year BBB fair yield curve effectively represents an upper bound estimate of the yield on similarly rated Australian corporate bonds. The Authority notes that the method used by Bloomberg to derive its fair value curves is not public.

If Bloomberg's estimate of the 7-year BBB fair yield curve is an upper bound estimate of the yield on similarly rated Australian corporate bonds, it would appear that a DRP derived from this data may not be "*...commensurate with prevailing conditions in the market for funds and the risks involved in providing reference services*" as required by, for example, the National Gas Rules.

Further, if Bloomberg's 7-year BBB fair yield curve did overstate the yield on similarly rated Australian corporate bonds, such overstatement may be compounded by extrapolating the duration of the yield curve to 10-years, as has been regulators' practice, in order to align the duration with that of other inputs to the derivation of the rate of return.

Recent determinations

Table A.1 below provides an overview of the estimate of the DRP underpinning recent determinations of Australian regulators. In each case, the DRP is referenced to 10-year BBB/BBB+ Australian corporate bonds.

Table A.1 Recent Australian Regulatory Decisions on Debt Risk Premium for a 10 year BBB/BBB+ Corporate Bond

Decision	Period of averaging for DRP observations	Methodology	DRP
ERA – Further Final Decision Western Power	10 November - 30 November 2009	Average of CBA Spectrum and Estimated Bloomberg Fair Value Curves	4.14%
AER - ACTEW/AGL Final Decision	15 February – 12 March 2010	CBA Spectrum Fair Value Curves	3.35%
AER – Jemena Gas Networks Final Decision	8 April - 6 May 2010	CBA Spectrum Fair Value Curves	2.93%
Victorian DNSP Revised Proposal Submitted to the AER	1 May – 31 May 2010	Estimated Bloomberg Fair Value Curves	4.28%
ERA – Draft Decision WAGN Access Arrangement	10 July – 30 July 2010	CBA Spectrum Fair Yield Curves	3.29%
AER – Victorian DNSP Final Decision	Approximately August 2010 * Exact period varied according to DNSP nominated averaging period	Average of Estimated Bloomberg Fair Value Curves (75%) and APT Bond (25%)	3.74 – 4.05% *Numbers varied according to DNSP nominated averaging period
ACG report to IMO on calculating WACC for determining Maximum Reserve Capacity Price 2013	6 October 2010 – 26 October 2010	Estimated Bloomberg Fair Value Curves	5.19%

Care must be taken in comparing DRPs given the different methods adopted by regulators in Australia, and the different periods for which DRPs were calculated (and hence the varying market conditions that applied at the time). Nevertheless, Alinta considers that the evidence provided by the Authority in its Discussion Paper and that in Table A.1 support consideration being given to alternative methods for estimating the DRP.

Alinta notes that estimates of the DRP drawing on Bloomberg fair value curves have tended to be materially higher, being consistently higher than 4 per cent, than estimates that relied only on CBASpectrum fair value curves. Further, if the recent estimate of the DRP based on Bloomberg fair values curves provided by the Allen Consulting Group (ACG) to the Independent Market Operator (IMO) (for the calculation of the Maximum Reserve Capacity Price under the Wholesale Electricity Market Rules) is accurate, the bias in the Bloomberg data may have increased.

Authority's proposed approach

Alinta understands that the Authority proposes to estimate the DRP based on a sample of Australian corporate bonds with varying terms to maturity.

The Authority's Discussion Paper indicates that using its proposed method estimates of between around 2.8 per cent and 2.9 per cent are derived. Alinta notes that such estimates are more than 40 per cent lower than the DRP derived by the ACG based on Bloomberg fair value curves for almost the same period.

1. Is the Authority's proposed approach of estimating the debt risk premium likely to better reflect the prevailing conditions in the market for funds than the current use of current Bloomberg's estimates of fair-yield curves?

2. Is the use of a benchmark sample of Australian corporate bonds with a term shorter than 10 years likely to better reflect the prevailing conditions in the market for funds than the use of Bloomberg's estimates of fair yield curves to derive a 10-year term?

As noted earlier, Figure 2 in the Authority's Discussion Paper indicates that Bloomberg's recent estimates of the 7-year BBB fair yield curve represent an upper bound of the observed yield on Australian corporate bonds. This would also imply that a DRP derived using Bloomberg's estimates of fair-yield curves would represent an upper bound of the DRP required by investors.

From this evidence, it appears reasonable to consider that the Authority's proposed approach of estimating the DRP would be likely to better reflect the prevailing conditions in the market for funds than the current use of current Bloomberg's estimates of fair-yield curves. As noted earlier, the Authority's Discussion Paper indicates that applying its proposed method results in estimates for the DRP of between around 2.8 per cent and 2.9 per cent. Such estimates are more than 40 per cent lower than the DRP of 5.19 per cent derived by the ACG apparently based on Bloomberg fair value curves for 10 years for almost the same period.

The absence of Australian corporate bonds with a term of 10 years (excluding the recently issued APT bond) might also be taken to indicate that the use of a benchmark sample of Australian corporate bonds with a term shorter than 10 years would be likely to better reflect the prevailing conditions in the market for funds than the use of Bloomberg's estimates of fair yield curves to derive a 10-year term.

However, Alinta suggests that the Authority consider updating Figure 3 of its Discussion Paper to include the four weighted bond series (simple average, years-until-maturity, amount-issued and median) that it constructs as part of its proposed approach. This would provide interested parties with a visual basis for drawing a conclusion as to the appropriateness of the Authority's proposed approach (similar to Figure 2).

In the absence of this information, Alinta does not believe that it is possible to conclusively conclude that:

- the Authority's proposed approach to estimating the DRP is likely to better reflect the prevailing conditions in the market for funds than the current use of current Bloomberg's estimates of fair-yield curves; or
- the use of a benchmark sample of Australian corporate bonds with a term shorter than 10 years is likely to better reflect the prevailing conditions in the market for funds than the use of Bloomberg's estimates of fair yield curves to derive a 10-year term.

3. Is the Authority's proposed approach to the selection of Australian corporate bonds appropriate?

Alinta considers it appropriate that international corporate bonds are excluded from the method used to derive an estimate of the DRP, and while using a selection of Australian corporate bonds issued by businesses operating in similar industries to the regulated entity to which the DRP would apply is preferable, the lack of observations may compel the Authority to consider a wider range of industry sectors.

Alinta notes that, in its review of the weighted average cost of capital (WACC) for electricity networks, the AER initially advocated adopting a DRP and risk-free rate based on the length of the regulatory period, being five years. The AER considered that aligning the DRP and risk-free rate to the regulatory period satisfied the 'present value' principle of the return on capital component of regulatory determinations, in that it only compensated regulated businesses for the risks faced over the regulatory period.

Nevertheless, evidence provided by regulated electricity networks indicated they did in fact issue debt for periods of longer than five years and that there was a preference for issuing longer-term debt. The AER subsequently also concluded that refinancing risk and hedging costs would not be adequately compensated for under a shorter period, and on this basis considered that using a 10 year period was appropriate in that it provided a conservative estimate expected to provide adequate returns to a regulated businesses.

To the extent that regulated businesses have a preference for issuing longer-term debt (as indicated by evidence to the AER's WACC review for electricity networks), it would appear that using shorter duration Australian corporate bonds to derive an estimate of the DRP may inadequately compensate investors unless the allowance for debt issuing costs was also reviewed.

An alternative approach might be to exclude corporate bonds with a term of less than 5 years (or alternatively the regulatory period), although this might not provide a sufficiently large sample from which to calculate the DRP.

4. Which method for calculating the weighted average of observed yields from the sample should be used?

As noted earlier, Alinta requests that the Authority consider updating Figure 3 of its Discussion Paper to include the four weighted bond series (simple average, years-until-maturity, amount-issued and median) that it constructs as part of its proposed approach. This would provide interested parties with a visual basis for drawing a conclusion as to the appropriateness of both the Authority's proposed approach and the method for calculating the weighted average of observed yields from the sample of Australian corporate bonds.

5. Are there any relevant sources of information that the Authority has not considered in this discussion paper with regard to estimating the debt risk premium?

While the National Electricity Rules limit the AER's discretion in considering alternative methods for estimating the DRP, Alinta suggests that its approach in benchmarking the recently issued APT 10-year corporate bond warrants closer examination, particularly given the similarity of the business to regulated transmission and distribution companies. The AER's approach would appear to compare favourably to the construct of a benchmark company, and appears to be compliant with the Australian Competition Tribunal 2003 GasNet decision regarding the suitable corporate bond term on which to base DRP calculations.

Alinta notes that the likely stability and consistency of the Authority's proposed method is currently unclear. Alinta suggests that the Authority may wish to consider back-casting estimates of the DRP using its proposed method to provide an indication of the likely future stability and consistency of the estimated DRP. For example, the Authority could derive DRPs for its past decisions using the new method.

Alinta Pty Ltd
7 January 2011