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Dr Michael Keating, AC
Chairman
The Independent Pricing and Regulatory Tribunal of NSW
Level 2, 44 Market Street
PO Box Q290
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Attention: Mr Colin Reid

Dear Dr Keating

**Draft Report and Draft Determinations on Prices of Water Supply,
Wastewater and Stormwater Services to 2009**

AGL's initial submission dated 15 July 2005, focussed on the potable water prices and pricing structures proposed in the Tribunal's Draft Determinations rather than on the prices proposed for other services or the process by which each entity's notional revenue requirement has been determined. In this supplementary submission we draw the Tribunal's attention to recent developments affecting the calculation of the rate of return on assets (WACC) which is a key determinant of revenue requirements and hence price levels generally.

The equity beta and debt margin are two significant factors in the WACC calculation. In AGL's view there is a strong case for the Tribunal to vary its position on both of those factors to produce a higher WACC:

Asset beta:

We note that, in its submission to the Tribunal dated 29 July 2005, the NSW Treasury proposes an equity beta in the range 0.8 to 1.0, but with the qualification that "this range is on the low side given that there is little evidence to justify moving from the default or 'null hypothesis' estimate of unity." (p12) We concur with this observation.

Debt Margin:

The Tribunal relies on yields estimated by CBASpectrum (Appendix A3.4). There is growing support for the view that the CBASpectrum method consistently understates the true value of the yield and that the bias increases as the term of the debt increases and its rating decreases. The consensus is that for 10 year BBB+ rated debt the true yield is of the order of 25 basis points higher than predicted by CBASpectrum. This view is supported by at least three analyses:

1. The Essential Services Commission of Victoria (ESC), is currently conducting an Electricity Distribution Price Review. In its Draft Decision the ESC, concludes that:

"As the under-estimation for CBA Spectrum would appear to rise as the term of the bond increases and its rating decreases, AGL's estimate that the under-statement is in the order of 25 basis points for a 10 year BBB+ bond would appear to be supported." and that, after due allowance for debt raising costs, "a debt margin of 130 basis points

(or 1.30 per cent) is reasonable for a BBB+ rated bond with a 10 year maturity.” (ESC, p310-311)¹

2. The Energy Networks Association (ENA) has made a submission to ESC, which includes a paper prepared by NERA. That paper supports the ESC’s conclusion:

“The CBASpectrum estimation procedure does not determine the best fit to the available data. The CBASpectrum estimation procedure is such that CBASpectrum estimated yields are expected to be, and in practice are, on average, less than actual yields for long dated, low rated bonds. ...

On this basis, we consider that the **minimum** reasonable adjustment to CBASpectrum estimates by regulators seeking to estimate the cost of debt on 10 year low rated debt is 22.2 basis points. 1 Using only data from CBASpectrum, our best estimate of the appropriate adjustment to CBASpectrum estimates of yields on 10 year debt rated A or below is to add 25.6 basis points.

The regulator might consider relying on a different data source such as Bloomberg. Bloomberg’s estimation procedure will not induce an expected difference between actual and estimated yields. Over the relevant period Bloomberg estimated fair yields that were 25.8 basis points higher than CBASpectrum for ten year BBB+ bonds. This is consistent with our independent assessment of a 25.6 basis point underestimate.” (NERA p2)²

3. The Allen Consulting Group (ACG) has reviewed the NERA work for the Economic Regulation Authority (ERA) in Western Australia in the context of ERA’s review of AlintaGas Networks’ proposed Access Arrangement. ACG conclude that:

“... the predicted excess of an actual bond yield over the CBASpectrum predicted yield at a 10 year maturity is strikingly similar between the two analyses, with the ACG estimate of 23.69 only 2 basis points lower than NERA’s estimate of 25.62, which is neither statistically nor economically significant. The regression equations above implicitly assume that all credit ratings have the same slope coefficient with respect to underestimation. This need not be the case, but there are too few observations to test alternative propositions.

Accordingly, the analysis presented above provides very similar results to NERA’s estimates of the understatement of predicted yields by the CBASpectrum service.” (ACG, p9)³

In AGL’s view these findings are equally relevant in the context of the Tribunal’s review of water service prices in NSW.

Should you wish to discuss this submission, please contact Chris Harvey on (02) 9921 2601

Your sincerely

Robert Wiles
General Manager Regulation and Policy

¹ ESC, June 2005, available at <http://www.esc.vic.gov.au/electricity833.html>

² ENA, July 2005 and NERA, May 2005, available at <http://www.esc.vic.gov.au/electricity1005.html>

³ ACG, July 2005, available at <http://www.era.wa.gov.au/library/Final%5FAGN%5Fdebt%5Fmargin%5Fmemo.pdf>