ATCO Gas
AUSTRALIA

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22nd December 2014

Mr Greg Watkinson
CEO
Economic Regulation Authority
Level 4, Albert Facie House
469-489 Wellington Street
Perth WA 6000

Dear Mr Watkinson,

RE: ATCO GAS AUSTRALIA'S RESPONSE TO THE ERA'S DRAFT DECISION

ATCO Gas Australia (AGA) submitted its response to the Economic Regulation Authority (ERA) Draft Decision on AGA's proposed revisions to the Access Arrangement for the Mid-West and South-West Gas Distribution System on the 27th November 2014.

The Authority has invited interested parties to make submissions on the Draft Decision by 4pm on 12 January 2015. By way of submission on the Draft Decision AGA submits this letter and the CEG report titled: *The new issue premium* together with a letter from CEG explaining the application of the report to the ERA's proposed methodology for estimating the cost of debt.

Since the submission of the response to the ERA's Draft Decision, AGA has identified the enclosed research paper on the value of new issue premium released on 5th December 2014 on the AER's website.

When a network business raises debt to fund expenditure it issues new bonds to bond holders. This is known as the primary market. The proposed sources of debt data used by AGA to measure the cost of debt are observations from the secondary debt market – that is the market in which debt issued in the past but which has not yet reached maturity is sold from one bond holder to another. *The new issue premium* report by CEG measures the difference between the price at which a network business can roll-over its debt portfolio and prices from secondary markets where the debt is resold.

There are a number of differences between the primary and secondary bond markets. For example, the quantum of debt that is the subject of an issue is much greater than the later secondary trade in bonds with only a small proportion (if any) re-traded each business day. As a result of these differences some of the academic literature suggests that yields in the secondary market may be downwardly biased. This implies that an upward adjustment (new issue premium) should be made to the yield estimates produced by sources that reflect trades in the secondary market when estimating the return on debt for the benchmark efficient entity.

AGA submits that while new issue premium studies have been previously examined in academic literature, these studies are of limited use in arriving at an estimate that is specific for the current regulatory context. The CEG study presents a consolidated view of the existing research and provides an estimate of the new issue premium based on Bloomberg BVAL estimates for bonds issued by Australian companies with 10 years maturity and a credit rating within the BBB band. None of the existing studies provide such an estimate.

The CEG report on the new issue premium measures the change in yields from issue relative to changes in yields of a bond market index. The current estimate of the new issue premium is 0.27%.

Taking this estimate into account and combining it with the cost of debt proposed by AGA would result in a cost of debt of 6.0% and a post-tax WACC of 7.8%. As demonstrated by CEG, the inclusion of a new issue premium in the calculation of the cost of debt estimate reflects the efficient costs of a benchmark efficient entity and satisfies the requirements of the ARORO.

	AGA Response to the Draft Decision	Effect of new issue premium
Return on equity	10.51%	10.51%
Return on debt	5.73%	6.00%
Rate of return	7.64%	7.80%

I invite the ERA to contact AGA should any further information or clarification be required to assist in the completion of the review process and the release of the Final Decision.

Yours sincerely

Sally McMahon
General Manager Regulatory and Risk