Review of Regulatory Credit Rating and Cost of Debt for Aurizon Network

Report to the Queensland Competition Authority

Agenda

INCENTA Economic Consulting

- Benchmark credit rating
- Benchmark debt margin
- Comments on Value Adviser Associates and Aurizon Network
- Benchmark debt raising transaction costs
- Interest rate swap transaction cost
- Estimates of total cost of debt

Benchmark credit rating

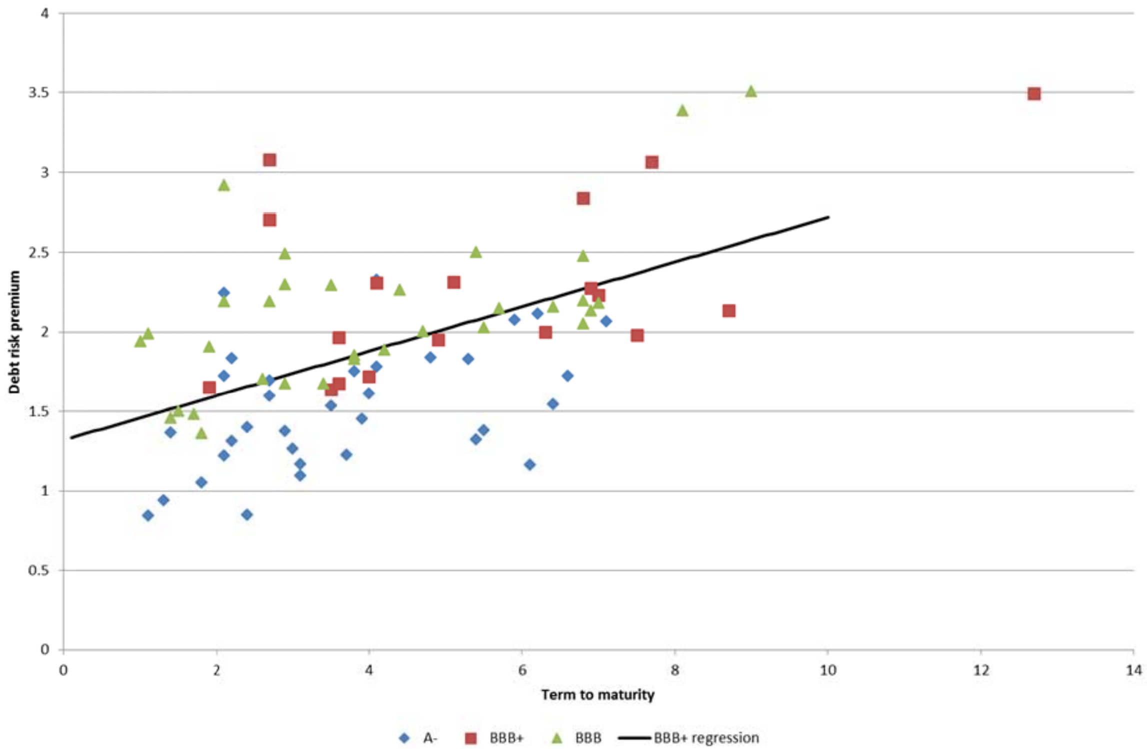
- Standard & Poor’s has applied a BBB+ stand-alone credit rating to AN
- Based on AN’s submission to the QCA, and the cost of debt we estimate the key metrics for UT4:
  - FFO/Interest cover of 3.2-3.4x
  - FFO/Debt ranging from 14% to 14.2%
- These would be strong metrics for a regulated energy business
- Lower forecast revenues should still imply BBB+ (FFO/Interest ≈ 3)

Benchmark debt margin

Regression analysis applying the PwC (2013) method

- 84 bonds
- BBB/BBB+/A- rated
- Linear DRP function
- DRP = 272 bp

  for 10 year BBB+ rating



Source: Bloomberg, UBS and Incenta analysis

Benchmark debt margin

Applying PwC (2013) ‘paired bonds’ analysis (which has been applied in a number of recent AER decisions) 10 year BBB+ DRP = 251 bp

Bond issues	Term of short bond (years)	Term of long bond (years)	DRP of short bond (bp)	DRP of long bond (bp)	Basis points per annum (bppa)
CBA Property Fund	6.15	9.16	211	227	5
GPT	5.27	8.83	183	205	6
SP AusNet	7.46	8.70	198	214	13
Sydney Airport	8.09	8.98	339	351	14
			Basis points per annum average		9.4
			3 times bppa		28.2
			Bloomberg BBB 7 year DRP		223
			‘Paired bonds’ extrapolated DRP		251

Comments on VAA and AN

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- VAA's first method obtained a similar DRP and Bloomberg 'paired bond' extrapolation numbers to PwC's report
- Agree with reference to Bloomberg, but question VAA's paired bonds
- Do not agree that VAA's methods 1 and 2 should give the same number –
    - interest rate swaps can reduce the base interest rate when it is certain the regulatory WACC will be set mechanistically in line with 'spot' interest rates at the next review
- Do not agree that there are no long bonds for econometric analysis
- Do not agree with AN's extrapolation using 2010 Bloomberg AAA FVC (not consistent with VAA, and out of date)
- AN's cost of debt estimates appear too low based on its intended methodology of extrapolating the Bloomberg 7 year BBB FVC

Benchmark transaction costs (bppa)

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We applied the PwC (2013) findings to the debt portion of AN's RAB

Number of bonds	Value	1 bond issued	11 bonds issued
Amount raised		$250 million	$2,750 million
Arrangement fee		8.51	8.51
Bond Master Program (per program)	$56,250	0.33	0.03
Issuer's legal counsel	$15,625	0.09	0.09
Company credit rating	$77,500	0.46	0.04
Annual surveillance fee	$35,500	0.14	0.01
Up-front issuance fee	5.20 bp	0.77	0.77
Registration up-front (per program)	$20,850	0.12	0.12
Registration - annual	$7,825	0.31	0.31
Agents out-of-pockets	$3,000	0.02	0.02
Total		10.8	9.9

Interest rate swap transaction cost

We engaged Evans & Peck as a sub-contractor, to estimate the benchmark swap transaction cost allowance (bppa)

- Transaction 1: 10 year fixed to 10 year floating
- Transaction 2: 4 year floating to 4 year fixed

	4 year	10 year
Credit rating	BBB+	BBB+
Execution spread	2.0	2.0
Risk spread	2.3	5.0
Benchmark swap cost	11.3	

Estimates of total cost of debt

Cost of debt estimates for 20 business days to 31 October, 2013 (%)

- Since the PwC (2013) report, the Econometric-Bloomberg relativities have switched from -7bp to +20bp

Row		Econometric methodology	Extrapolated Bloomberg
1	Risk free rate (4 year CGS)	3.211	3.211
2	10 year Debt Risk Premium	2.720	2.513
3	Debt-raising transaction costs	0.099	0.099
4	Interest rate swap costs	0.113	0.113
5	Total cost of debt	6.14	5.94