George Passmore
Director of Business Performance
Queensland Competition Authority
Level 27, 145 Ann Street
Brisbane, QLD 4000

Aurizon Network Proposed Schedule F Reset Values

14 September 2023

Dear George,

Aurizon Network has prepared this submission to provide additional information in respect of the Reset Debt Risk Premium (**DRP**) estimate included in its Proposed Schedule F Reset Values submitted to the Queensland Competition Authority (**QCA**) on 31 July 2023.

In preparing the DRP estimate, Aurizon Network has applied the bond filtering methodology described in the QCA's Final Decision on the 2017 Draft Access Undertaking (**QCA 2018 Decision**). This methodology includes a requirement to:

> *adopt the lower credit rating if there were two divergent ratings one notch apart.*

Aurizon Network recognises this requirement may be subject to an alternate interpretation in respect of a lower credit rating and that the QCA 2018 Decision does not provide an example of its application. In applying this requirement, and consistent with the preparation of the submitted preliminary Schedule F Reset Values, Aurizon Network has interpreted and applied the lower credit rating based on the lower credit risk rating. For example, AER[1] defines the credit rating as:

> *Credit Rating - A value assigned by ratings providers (S&P, Fitch, Moody's) that groups businesses into similar risk bandings. Commonly it takes the form of a letter rating (AAA, A, BBB etc.) with AAA denoting lower risk and CCC the highest risk of default.*

As an alphanumeric scale, Aurizon Network has applied the lower credit risk rating to mean an A rated bond has a lower credit risk rating than an A- rated bond. Aurizon Network acknowledges that the alternate interpretation may consider the rating in the form or a ranking

---

[1] Australian Energy Regulator (2020) Energy Network Debt Data: Final Working Paper, November, p. 37.
https://www.aer.gov.au/system/files/Energy%20Network%20Debt%20data%20-%20Position%20Paper%20-%20Version%20to%20Publish%20-%20November%202020.pdf

where '*a corporate bond that is rated 'AA' is viewed by the rating agency as having a higher credit quality than a corporate bond with a 'BBB' rating*'[2].

In principle, with a large bond sample size and few bonds with alternate ratings one notch apart, the adoption of either approach would not be expected to materially influence the regression results. If this expectation did not hold, then the results may be either upward or downward biased.

Aurizon Network has reviewed the Expanded Bond Sample and identified 21 bonds by 7 issuers with two divergent bond ratings one notch apart as summarised in Table 1.

Table 1 Bonds in Expanded Bonds Sample with two divergent bond ratings one notch apart

Issuer	Number of Bonds	Rating A	Rating B	Applied Rating	Alternate Rating
Telstra Corp Ltd	8	A	A-	A	A-
AGI Finance Pty Ltd	4	A-	BBB+	A-	BBB+
Ausgrid Finance Pty Ltd	4	BBB+	BBB	BBB+	BBB
DBNGP Finance Co Pty Ltd	1	A-	BBB+	A-	BBB+
Energy Partnership Gas Pty Ltd	1	A-	BBB+	A-	BBB+
Newcrest Finance Pty Ltd	2	BBB	BBB+	BBB+	BBB
Santos Finance Ltd	1	BBB	BBB-	BBB	BBB-

The table above shows the rating credit applied by Aurizon Network and the alternate credit rating. The application of the alternate credit rating has the following implications for the Expanded Bond Sample:

- the 8 Telstra bonds would be added to the sample;
- 6 A- rated bonds would be reclassified as BBB+ bonds;
- 6 BBB+ rated bonds would be reclassified as BBB bonds; and
- the Santos bond would be removed from the sample.

Table 2 summarises the regression results for the Expanded Bond Sample for both the dummy intercept regressions and the BBB+ only bonds sample regression and the resultant average DRP estimates included in the Proposed Schedule F Reset Values.

Table 2 Summary of Average DRP Estimates in Proposed Schedule F Reset Values

Leverage cut-off (multiple of average)	3	2	3	2
Standardised residual cut-off	**3**	**3**	**2**	**2**
Expanded Sample Dummy Intercept Regression	2.41	2.41	2.41	2.45
Expanded Sample BBB+ only	2.47	2.50	2.46	2.58
RBA Yield Interpolation of RBA Yields	2.47	2.47	2.47	2.47
Average	**2.45**	**2.46**	**2.45**	**2.50**

[2] S&P Global. Guide to Credit Ratings Essentials: What are credit ratings and how do they work?, p. 4, https://www.spglobal.com/ratings/_division-assets/pdfs/guide_to_credit_rating_essentials_digital.pdf. Date accessed: 1 September 2023.

Table 3 summarises the regression results for the Expanded Bond Sample for both the dummy intercept regressions and the BBB+ only bonds sample regression and the resultant average DRP estimates obtained from applying the alternate interpretation to a lower credit rating.

The DRP estimates obtained from the application of the alternate credit ratings are predominantly consistent with those obtained from the applied credit ratings. The notable exception is the reduction in the DRP estimate from the dummy intercept regression with the lower statistical threshold for leverage of 3. Aurizon Network notes this is largely a consequence of 12-15 year term bonds with low DRP estimates, which are subsequently excluded when considering the higher threshold of 2 for standardised residuals (i.e. DRP increases from 2.34 to 2.43).

While the lower bound of the reasonable range reduces from 2.45 to 2.42, the proposed DRP estimate of 2.48 remains within the reasonable range of 2.42 to 2.51.

Table 3 Summary of Average DRP Estimates using alternate Credit Ratings in Table 1

Leverage cut-off (multiple of average)	3	2	3	2
Standardised residual cut-off	3	3	2	2
Expanded Sample Dummy Intercept Regression	2.34	2.40	2.43	2.44
Expanded Sample BBB+ only	2.45	2.59	2.46	2.61
Yield Interpolation of RBA Yields	2.47	2.47	2.47	2.47
Average	**2.42**	**2.49**	**2.45**	**2.51**

Due to the implications of 6 bonds being included in the BBB+ rating and 6 bonds being excluded from the BBB+ rating, Aurizon Network has also evaluated the BBB+ regression estimates obtained from a sample excluding these bonds (i.e. a revised BBB+ bonds sample that does not include either an upward or downward bias). The DRP estimates obtained from this restricted unbiased sample is shown in Table 4.

Table 4 BBB+ DRP Estimate obtained from BBB+ sample excluding bonds with alternate ratings

Leverage cut-off (multiple of average)	3	2	3	2
Standardised residual cut-off	3	3	2	2
Expanded Sample BBB+ only	2.45	2.45	2.50	2.50

Again, Aurizon Network's proposed Reset DRP estimate of 2.48 is consistent with the range of DRP estimates obtained from an unbiased sub-sample of BBB+ bonds in the Expanded Bond Sample.

I trust this information further assists the QCA in its assessment of the DRP for the Proposed Schedule F Reset Values. Should you have any further questions please contact Michael Bray via email michael.bray@aurizon.com.au.

Kind regards,

Jon Windle
Manager Regulation
Aurizon Network