



17 October 2013

Mr Warwick Anderson  
General Manager – Network Regulation Branch  
Australian Energy Regulator  
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By email: [rateofreturn@aer.gov.au](mailto:rateofreturn@aer.gov.au)

Dear Mr Anderson

### **AER Draft Rate of Return Guideline – Choice of benchmark term of debt**

The Australian Financial Markets Association (AFMA) represents the interests of over 130 participants in Australia's wholesale banking and financial markets. Our members include Australian and foreign-owned banks, securities companies, fund managers, treasury corporations, traders across a wide range of markets and industry service providers. Our members are the major providers of services to Australian businesses and retail investors who use the financial markets.

AFMA welcomes the opportunity to comment on the AER Draft Rate of Return guideline – August 2013 and commends the work that has been done to date on the Better Regulation reform program to deliver an improved regulatory framework in the electricity sector. However, there is one aspect of the Draft Rate of Return Guideline that we would like to bring to your attention.

We have concerns with respect to the proposed benchmark term of debt of seven years, as opposed to the previously adopted 10 year benchmark. We believe that the choice of debt benchmark should be in accordance with an overriding principle of asset/liability matching, failing any compelling reasons to the contrary.

The reasons provided in your Explanatory statement for the choice of 7 years over 10 years are not compelling in our opinion. An analysis of the arguments provided can be found in the following section.

Furthermore, the adoption of this benchmark has important implications for the sizable borrowing strategies in the capital markets of the regulated entities and the entities that borrow on their behalf. One of the downstream consequences of this is that it limits the capacity of those managers entrusted with the savings of Australians to allocate funds into debt products which match their liability profile. AFMA believes that a 10 year benchmark for the return on debt calculation would be more suitable for this purpose.

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## **The rationale behind a long-term benchmark for debt**

As noted in your Explanatory Statement (p. 109), the proposal for a 10 year equity term is on the basis that “regulated energy network service providers invest in long-lived assets which will generate regular cash flows over a similarly long term”. All other things being equal, this rationale is equally applicable to the choice of term for the debt benchmark.

The principle of asset/liability matching is as applicable to regulated network entities as it is in the banking and asset management world. In short, entities with longer-term assets should match as best as possible these assets with longer-term liabilities. Adhering to this principle helps minimise both interest rate risk and refinancing risk. The principle of asset/liability matching should be the overriding principle in the choice of benchmark term, as the choice of term has a significant influence on a regulated entities interest rate risk management strategy.

Given that this rationale has been used for the choice of equity term of 10 years, it follows that this should be the starting point for the choice of debt term as well, failing any compelling reasons to the contrary.

## **Arguments for a shorter benchmark term in the Explanatory Statement**

The Explanatory Statement (7.3.3) cites three main reasons for the choice of benchmark term of seven years. These are:

- Available evidence suggesting that the average term of existing debt is less than ten years;
- A requirement for updating to be mechanistic; and
- A view that the term premium between 7 and 10 years is immaterial

### *Available evidence*

The statement reports that the available evidence suggests that the average effective term of debt is likely to be less than 10 years. However, the evidence cited includes the following:

- 2009 WACC Review estimates a term of 7.37 years (after accounting for hedging);
- Some businesses report that the term is around 10 years
- Other businesses suggest that the average term should be around 10 years; and
- Support from PwC and CEG data for a 10 year term.

In our view, it is only the first bullet point that suggests a benchmark other than 10 years, and this appears to be fairly dated evidence, and potentially miscalculated given the admission that it is after accounting for hedging. All the other bullet points suggest a 10 year term is more appropriate.

There is also some discussion around the idea that a regulated business “can make use of interest rate swaps to bring down the cost of debt”. This appears to suggest that interest rate swaps are a cost management tool, rather than an interest rate risk management tool, which they are in practice. In fact, and particularly in light of recent international regulatory developments, interest rate swaps add a number of additional

costs, rather than reduce the cost of debt as suggested. Hence this argument, in our opinion, adds no weight to the case for 7 years.

In addition, and as noted in section 6.3.3, some of the debt financing practices of the regulated businesses are the product of the regulatory framework. It follows then that to use these as evidence for determining a new regulatory framework produces a circular argument. We would suggest that evidence from overseas based network entities may have helped provide some more independent guidance, but there is no evidence presented here to draw a conclusion.

On the whole, we believe that the “available evidence” argument is not compelling enough to override the previously mentioned overarching principle of asset/liability matching.

#### *Mechanistic updating*

We understand the preferences for a third party provider, and a desire to have the process as mechanistic as possible. We note that your preference in this regard is the Bloomberg Fair Value Curve, and that this only goes out to a 7 year maturity at present.

It appears that your conclusion is that mechanising the process is in the “too hard” basket, particularly in the process of extrapolating a term premium extrapolation of seven to 10 years from the current 7 year BFV debt risk premium or 7 year BFV yield.

We suggest that there may be other mechanistic ways of determining a suitable 10 year benchmark, and that this issue can and should be explored further. For example, you could use the AFMA 10 year swap rate as the initial starting point (which would account for a significant component of the debt risk premium as previously defined) and then add a margin for the BBB versus swap component at the 10 year mark. This margin can be estimated using the difference between the 7 year BFV yield and the 7 year swap AFMA swap rate as a starting point with some form of additional adjustment for the 7 year to 10 year BBB curve.

Mechanistic calculation of benchmarks is not an uncommon issue for risk managers in financial institutions, which form the core of AFMA’s membership base. AFMA would be more than happy to advise further about our suggested solution or discuss other potential methods to achieve your objective in a mechanistic manner from third party providers.

#### *The term premium*

The statement suggests that the difference in term premium between 7 year and 10 year BBB rates is immaterial, stating that the average difference is 21 basis points. Whereas this might be the average, it would be more beneficial to analyse both the maximum and minimum of this number.

A review of the difference between the 7 year and 10 year swap rate for the last 10 years shows a maximum spread of 40bp and a minimum spread of -23bp. In fact, the current spread between 7 year and 10 year swap is approximately 35 basis points. This swap difference is only a proxy for the curve differential in the BBB curve, which is likely to be wider, as lower credits tend to have steeper curves. This suggests that, at times,

the term premium between 7 year and 10 year debt can be quite material, contrary to your analysis.

### **Implications for the bond markets**

Given the size of the electricity and gas networks in Australia, the amount of borrowing required to fund these businesses is substantial, and hence the setting of the debt benchmark has a material effect on the sizable borrowing strategies of those businesses being regulated.

It is reasonable to expect that the changing of the debt benchmark from 10 years to 7 years will have a material impact on actual issues of every borrower affected. In short, a “shortening” of the debt benchmark will have a commensurate “shortening” effect on the actual debt issued by these authorities, all other things being equal.

One of the key components of establishing well-functioning debt capital markets in Australia is the establishment and extension of benchmark debt curves, such as those by the Commonwealth and State Governments. The Federal Treasurer has recently expressed a desire to extend the Commonwealth yield curve and will likely look to do so in coming quarters. His comments highlight some of the benefits that stem from government authorities issuing longer dated debt:

- Provide clear benchmark pricing and hedging opportunities for the private sector across many tenors;
- Reduce refinancing risks for borrowers such as infrastructure entities;
- Assist in the development of a deeper and more vibrant corporate bond market;
- Assist in providing opportunities for infrastructure-related issuance;
- Assist in providing cheaper financing opportunities for all borrowers over time; and
- Provide superannuation funds and other long-term investors with opportunities to match their own asset base.

This last point is worth expanding on. In the same way that asset-liability matching is a key principle for borrowers, it is equally applicable on the investment side.

Superannuation funds in Australia are expected to grow from \$1.5 trillion to \$3 trillion by the end of the decade. These funds have liabilities which are long-term in nature, and hence the need to match with long-dated debt is an important ongoing issue. It makes sense that those investors with long-term liability profiles, such as superannuation funds and life insurance companies, have opportunities to invest funds into debt products issued by borrowers who have the opposite liability profile, such as the infrastructure sector.

AFMA believes that by setting a 7 year debt benchmark for network borrowers as opposed to a longer term benchmark such as 10 year, the AER is limiting the development of the Australian debt capital markets when it could be taking a more leading role in this regard.

## **Conclusion**

AFMA believes that the choice of debt benchmark in the AER Draft Rate of Return should be based on an overriding principle of asset/liability matching, and that a 10 year benchmark is more suitable than the suggested 7 year one.

Furthermore, we feel that by setting a shorter benchmark than that which is currently in existence, this decision will have a large impact on the sizable issuing strategies of the regulated entities, whom will most likely issue shorter debt in response to the change.

Given that the development of well-functioning debt capital markets benefit from the establishment and maturity extension of benchmark curves, the choice of a shorter benchmark and its ensuing impact on the debt profile of borrowers is not a positive move in a number of respects. In particular, it limits the capacity for Australians to match their long-term liability profiles with longer term debt assets.

AFMA appreciates the opportunity to provide comment to the Draft Rate of Return guideline. Please do not hesitate to contact me on any of the matters raised in this submission.

Yours sincerely

A handwritten signature in black ink, appearing to read "M. Chadwick". The signature is fluid and cursive, with a long horizontal stroke at the end.

**Mike Chadwick**  
**Director Markets**