RoR CRG

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# Estimating the allowed return on debt – response to discussion paper

Dear Mr Anderson

Please note the following submission in response to the AER's Discussion paper - Estimating the allowed return on debt, May 2018

## Introduction

As part of the Rate of Return Guideline (Guideline) Review (the Review) the Australian Energy Regulator (AER) is required to determine the allowed rate of return for debt. This letter responds on behalf of the Consumer Reference Group to the *Estimating the allowed return on debt: Discussion paper* (the Paper) issued in May.

The Paper is slightly mistitled. The allowed return on debt is determined by the AER, the process of estimation is used by the AER in making that determination. The approach adopted in the 2013 Guideline is to use a trailing average approach that requires the estimation of the cost of debt each year. The AER has also developed a process for transition to this trailing debt approach.

As outlined in the CRG's Submission to the Review, we support the continued application of the trailing average methodology and the transition approach.[1] The Paper is addressing the approach the AER takes to determining the prevailing return on debt to be applied each year within that overall methodology and approach.

The CRG repeats its fundamental concern as outlined in our Submission that the current approach to determining the allowed rate of return does not contribute to the achievement of the energy objectives to the greatest degree (the standard proposed for the new Binding Instrument) and that it results in significant over-compensation of networks and distorted incentives. In the Submission we outline the information requirements and approach that the AER should use in future.

The remainder of this response is developed in the context of the AER's current framing, that is, how to use an observed data series to establish an allowed return on debt commensurate with the efficient finance costs of a benchmark efficient entity.

The CRG notes that there is no simple index to reflect the debt costs of the regulated businesses and that the AER's approach is to use third party data series as an appropriate market measure to

[1] https://www.aer.gov.au/system/files/Consumer%20Reference%20Group%20submission.pdf

determine the efficient financing costs of a 'benchmark efficient entity'.[2] The CRG broadly supports this approach and it is certainly preferable to an actual cost approach. However, just as with all other aspects of the rate of return the results arrived at by estimation, these estimates need to be compared to (and then informed by) the observed practices of networks.

The CRG notes that the Chairmont report provided with the Paper identifies that on average over the last 4 years the allowed return on debt has averaged 70 basis points more than the actual cost incurred by networks. That is, the current approach is not estimating anything like the efficient financing costs of a benchmark efficient entity.

This submission addresses the questions as they have been raised in the Paper. However, the CRG submits that the AER should seriously consider the conclusions of the Chairmont report and consider setting the return on debt as a defined margin (160 basis points) above the Bank Bill Swap rate.

## Credit rating

The data provided by the AER indicates that the current credit rating of the regulated businesses is on average BBB+. The benchmark efficient entity is presumed to be a pure play business offering only the regulated services. As returns on these services are guaranteed by the regulatory framework, it is reasonable to assume that the credit rating of the 'pure play' entity would be higher than that for all providers.

Further, to the extent that an entity's actual credit rating is below the benchmark the entity has options such as (a) disposing of assets with a riskier profile or (b) raising additional equity capital.

Further, the CRG again notes the observation by the Consumer Challenge Panel in their response to the Review Issues Paper that the actual cost of debt for the network businesses is less than the cost of debt for a general BBB+ plus rated firm.

The CRG therefore supports the continuation of the BBB+ credit rating.

## Selection of yield curve provider

The AER currently uses a simple average of two data series , the Reserve Bank of Australia (RBA) and Bloomberg's (BVAL) as the basis for determining the allowed cost of debt. Since then two other series have become available, Thomson Reuters (TR) and Standard and Poor's (SP).

No individual data series is best, and the AER adopted a simple average of the two existing series to gain the benefits of each. Apart from only providing monthly not daily estimates, the RBA series is generally regarded to be a superior series. The daily results are apparently derived using a linear interpolation.

ECA considers that the RBA remains the most robust measure, and it should always constitute 50% of the estimate of return of debt. ECA considers that there are benefits to including other data series, for diversity and resilience. Subject to any further considerations raised by the AER, ECA considers that both TR and S&P should be added to the estimation, noting that BVAL is more robust than the other two. The proportions should be specified as BVAL contributing no less that 25%, with any further data services contributing in equal shares of the remaining 25%.

As noted in our original submission the specification of the formula should cover every scenario, and could be structured as:

[22] These concepts drawn from the ARORO are perceived to be relevant even if the AER process changes to being the making of a binding instrument.

1. if the RBA is available it will be given a weight of 50%
2. If the BVAL is available, it will be given a weight of 50% of whatever is left after RBA has been given a weight
3. If TR and/or S&P are available, they will be equally weighted to make up the remainder after RBA and BVAL have been weighted.

## Benchmark term

The AER commissioned Chairmont to the debt data provided by the networks. Unsurprisingly, the report revealed that the providers actively manage their debt portfolios including taking out shorter term debt when rates are high, and longer-term debt when they are low.

This creates a particular challenge for the AER in establishing a benchmark rate of return on debt. This is further compounded by the use of a trailing average approach to debt that only makes sense if it is assumed that debt is raised for the same term as the averaging period.

The weighted average term of issuance determined by the AER is 7.4 or 7.5 years, and as a consequence the use of a ten year term overestimates the return on debt compared to actual debt costs.

This raises, however, the important question of why the regime treats debt as an element of return on capital rather than just compensating for interest payments as an operating expense, or worse, as a straight *ex post* compensation. These approaches reduce the incentive for the network to reduce their costs of debt.

However, if the entire benefit of a lower cost of debt is captured by the network then this isn't an effective incentive. There are two possible approaches to this.

One is to simply recognise that the actual cost of debt will be ratcheted dob networks over time and so the allowed return on t should be ratcheted down. The second would be to treat interest as an operating expense and at the end of a regulatory period compare the network's actual interest cost to their allowed interests cost, and if it was under the allowance allow the network to retain 30% of the saving and return the other 70% in the next control period.

This, however, is beyond the scope of the current review which is still grounded in the existing Rules.

It is the CRG's view that the fact that the network's actual debt issuance practice is a shorter than ten year term should be reflected in a small fixed reduction from the benchmarked return. However, we also note the Chairmont data that shows that most recent issuances have been closer to 10 years and that this issue really relates more to allowed returns on debt in earlier years that have now been "baked in" to the trailing average.

## Implementation of the benchmark credit rating

It is clear that using a broad-BBB series will over-estimate the allowed return on debt that will be provided to a business with a BBB+ credit rating. This becomes even more egregious when it is realised that the relationship between credit rating and interest rate is not exact and that regulated networks benefit from slightly lower rates than other BBB+ businesses.

Using a broad-A series and averaging it with the broad-B series is one useful approach, and the CRG would support this approach.

However, even using a 2:1 ratio to weight the A and BBB series only slightly closes the gap between the AER series and the industry index.

## A radical alternative

The Chairmont report has generated an Energy Infrastructure Credit Spread Index (EICSI) which from Graph 1 of the report ranges from a spread of just over 120 basis points to 160 basis points. This is compared to the current AER Index in Graph 2, with the AER index ranging from about 170 to 270 basis points.

The report identifies this difference as being caused by borrowers varying their average term to reflect the prevailing interest rate environment. The comparison between the EICSI in Graphs 1 to 3 with the average rating in Graph 4 suggests that recent variation can be explained by the change in average credit rating; as average rating has improved the EICSI has declined – a BBB+ credit rating aligns to a spread of 150 basis points.

This provides the possibility of an alternative approach which is to set the return on debt by using the EICSI result directly – to allow some space for over-peformance a rate of return that allowed a spread of 160 basis points on the Bank Bill Swap Rate is the most accurate estimate of the efficient debt financing cost of a benchmark efficient entity.

## Response to questions

1. Does the evidence support continuation of a BBB+ credit rating or a change? If it supports a change, what should the benchmark credit rating be?

   *The BBB+ rating remains appropriate.*

2. What are your views on the relevance of market expertise of the above providers with respect to estimating corporate debt yield curves for our purposes?
3. Having regard to the available evidence, are any of the curves clearly superior to the other curves in terms of their overall fitness for purpose?
4. How should we consider the impact of adjustments to curves away from their published form when deciding on the curves to use in our benchmark?
5. How should we consider the impact of curve availability over time when deciding on the curves to use in our benchmark?
6. How should we have regard to curve outcomes over time when deciding on the curves to use in our benchmark?

   *Assuming the legislation to make a binding rate of return instrument is enacted the method for estimating the benchmark return on debt needs to be robust across the term of the instrument. The value of the inclusion of additional data series in this construct is greater robustness if any data series ceases to be available.*

   *Unfortunately, to be effective in combination does require the adjustments to be made to each*

7. In your view, does this evidence support a change to the benchmark term of debt? In answering this question, please address:

   (a) The impact of a change on term to the trailing average approach, including whether this change would have long term or transient impacts

   (b) The implications of such a change for regulatory certainty given the multiple period commitment that may be implicit in the transition to the trailing average

(c) The appropriate way to establish a benchmark if there is evidence of multiple distinct term issuing practices amongst networks?

(d) The longer term data on benchmark term to maturity as estimated in previous rate of return review processes.

*The question of whether the impact of a change on term on the trailing average approach is long term or transient is largely irrelevant. It will have an impact and the last thing we need is some additional process to determine what this impact is.*

*Further the data in Figures 2 and 4 of the Paper indicate that there is a lot of variability in the average term; it has ranged from a low of just over 4 to a high of nearly 10.*

8. How should we implement the benchmark credit rating? In particular, what do you consider is the appropriate broad-curve rating to use?

   *If the allowed rate of return is to be set by matching it to a calculation from a broad-curve it should be a weighted average of a broad A and BBB curve, though a weighting of 3:1 may be better than 2:1.*

Yours sincerely

John Devereaux

Chairman

Consumer Reference Group