

**SUBMISSION ON THE AER'S DRAFT
DISTRIBUTION DETERMINATION 2011-
2015, APPENDIX P: DEBT RAISING COSTS**

19 August 2010

This submission sets out CitiPower Pty (**CitiPower**) and Powercor Australia Limited's (**Powercor Australia**) response to Appendix P of the Australian Energy Regulator's (AER) Draft Decision Victorian electricity distribution network service providers Distribution determination 2011-15 dated 4 June 2010 (**Draft Determination**) in relation to debt raising costs. It also explains how CitiPower and Powercor Australia calculated the allowances for debt raising costs that are set out in their Revised Regulatory Proposals that were lodged with the AER on 21 July 2010 (**Revised Regulatory Proposals**).

Attached to this submission is a witness statement from Julie Williams, CitiPower and Powercor Australia's Chief Financial Officer, addressing early refinancing costs (**Ms Williams' witness statement**).

Ms Williams' witness statement contains information that was provided in confidence by third parties. CitiPower and Powercor Australia claim confidentiality in accordance with section 18 of the National Electricity law and section 44AAF of the Trade Practices Act 1974 in relation to the information identified as confidential in Ms Williams' witness statement, including the annexures to Ms Williams' witness statement that are identified as confidential. A public version of Ms Williams' witness statement with those confidential sections removed is also attached.

Capitalised terms that are not defined in this submission have the meanings set out in Ms Williams' witness statement.

1. Summary of key points

1.1 Early refinancing costs

This submission focuses on early refinancing costs, which the AER refers to as 'the completion method' in the Draft Determination.

For the reasons set out in Ms Williams' witness statement, CitiPower and Powercor Australia consider that:

- A prudent operator would act to reduce refinancing risk by refinancing all of its maturing debt at least 3 months prior to maturity using a method that was sufficiently committed so that the firm has certainty that funds will be available on the maturity date.
- The potential methods that a prudent operator would consider to manage refinancing risk are the Completion Method, the Commitment Method, the use of cash reserves, or a Committed Bank Loan Facility.
- The form of underwriting that was considered and costed by the AER in the Draft Determination is known as a 'book build' underwriting. This form of underwriting only provides underwriting cover for a very short period of 3 to 7 days. It is not used for the purpose of managing refinancing risk, and is instead only used for the purpose of issuing the bonds to investors via the lead arranger books. Underwriting to reduce refinancing risk would need to cover a period of at least 3 months, as accepted by the AER in the Draft Determination. Accordingly, underwriting of the kind considered by the AER in the Draft Determination does not reduce refinancing risks.
- It is not possible to secure underwriting for a sufficiently long period to make it a prudent option to manage refinancing risk. Accordingly, the Underwriting Method would not be adopted by a prudent operator to manage its refinancing risk.

- Of the three methods considered by the AER in the Draft Determination (Completion Method, Commitment Method and Underwriting Method), the most efficient (ie lowest cost) option that reduces refinancing risk to the extent that would be undertaken by a prudent operator is the Completion Method, which has a cost of 16.5-18.5 basis points per annum (**bppa**). There is also considerable evidence of the use of the Completion Method by comparable electricity and gas operators, which demonstrates that it is an efficient method that would be adopted by a prudent operator in CitiPower and Powercor Australia's circumstances.
- A short-term Committed Bank Loan Facility established specifically to manage refinancing risk arising from a maturing capital market debt may provide a lower cost option, with an estimated cost of 12.5 bppa. However, its use is much less common amongst firms that are comparators to CitiPower and Powercor Australia. This method will require additional time and resources and impose indirect costs that are not included in this cost estimate, and will impose strain on the firm's relationship with its banks. As a result, a prudent operator is unlikely to use a Committed Bank Loan Facility as its sole method of managing refinancing risk.
- The direct debt raising costs allowance does not include an allowance for costs to reduce refinancing risks to the extent that would be required by a prudent operator. A separate allowance for early refinancing costs is therefore required.

CitiPower and Powercor Australia propose that the AER should include an allowance for early refinancing costs that is equal to the average of the Completion Method with no buyback and a Committed Bank Loan Facility. This amount should be in addition to the allowance for direct debt raising costs.

Based on the averaging period of 1 March to 19 March that the AER used in the Draft Determination, this allowance for early refinancing costs would be equal to 15.5 bppa. This amount should be recalculated by the AER using CitiPower and Powercor Australia's agreed averaging period prior to the AER's impending final determinations (**Final Determination**).

1.2 Direct debt raising costs

This submission also briefly addresses CitiPower and Powercor Australia's proposed direct debt raising costs, including correcting an inadvertent error in CitiPower's Revised Regulatory Proposal.

CitiPower and Powercor Australia accept the amount of direct debt raising costs set out in the Draft Determination (9.1 bppa for Powercor Australia and 9.3 bppa for CitiPower), but do not agree that this amount of direct debt raising costs includes an allowance for early refinancing costs.

2. CitiPower and Powercor Australia's Initial Regulatory Proposals

In their Initial Regulatory Proposals dated 30 November 2009, CitiPower and Powercor Australia proposed direct debt raising costs of 12 bppa and early debt refinancing costs of 16.6 bppa as an element of their operating expenditure forecasts.¹

¹ Powercor Australia's Initial Regulatory Proposal pp188-190; CitiPower's Initial Regulatory Proposal, pp214-215.

3. AER's Draft Determination

In the Draft Determination, the AER did not accept CitiPower and Powercor Australia's proposed debt raising costs. In Appendix P of the Draft Determination, the AER concluded that the appropriate amount of direct debt raising costs was between 9.0 and 10.8 bppa (depending on the number of debt issues) and that an additional allowance for early refinancing costs was not appropriate.²

In the Draft Determination, the AER builds on, and refers in numerous places to, its approach and decision in the AER's 'Draft decision South Australia Draft distribution determination 2010-11 to 2014-15' dated 25 November 2009 (**South Australian Draft Determination**) and the AER's 'Final decision South Australia distribution determination 2010-11 to 2014-15' dated 4 May 2010 (**South Australian Final Determination**).

In the Draft Determination, the AER accepted that it is prudent for a Distribution Network Service Provider (**DNSP**) to have a plan to eliminate debt refinancing risks and that early refinancing costs are a legitimate expense for which DNSPs should be compensated.³

The AER noted that its assessment of a DNSP's proposed debt raising costs is governed by clause 6.5.6 of the National Electricity Rules (**Rules**). Clause 6.5.6(c) of the Rules provides that the AER must accept a DNSP's forecast of operating expenditure if it is satisfied that the forecast expenditure reasonably reflects:

- the efficient costs of achieving the operating expenditure objectives;
- the costs that a prudent operator in the circumstances of the DNSP would require to achieve the operating expenditure objectives; and
- a realistic expectation of the demand forecast and cost inputs required to achieve the operating expenditure objectives,

(the operating expenditure criteria).

The AER stated that:

*'The operating expenditure of a DNSP is assessed with regard to prudence, as required by clause 6.5.6(c)(2) of the NER, and in the assessment the AER must have regard to benchmark opex that would be incurred by an efficient DNSP, as required by clause 6.5.6(e)(4). Therefore, where close comparators to the benchmark firm are observed to undertake a particular action, this supports the conclusion that such an action is prudent.'*⁴

The AER considered that any of the Completion Method, the Commitment Method or the Underwriting Method, and potentially other methods, are prudent ways of managing refinancing risk. The AER considered that the most efficient method of managing refinancing risk was the Underwriting Method. The AER's estimate of the amount of early debt refinancing costs was 4-8 bppa, based on the Underwriting Method.⁵

² AER, Draft Determination Appendices, Appendix P, pp337 and 345.

³ AER, Draft Determination Appendices, Appendix P, pp 339 and 345.

⁴ AER, Draft Determination Appendices, Appendix P, p340.

⁵ AER, Draft Determination Appendices, Appendix P, p343.

However, the AER considered that the costs of early debt refinancing were already included in the allowance for direct debt raising costs.⁶ This conclusion was based on the AER's views that:⁷

- the ACG Report on which the allowance for direct debt raising costs is based⁸ was a comprehensive review and it is reasonable to conclude that ACG took into account the need for a refinancing plan when estimating debt raising costs;
- the ACG Report includes an allowance for underwriting costs of 7.2 bppa;
- the PwC Report relied on by ETSA Utilities in the South Australian distribution determination process⁹ does not refer to excluding costs that are already included in the direct debt raising costs allowance; and
- the ACG underwriting cost allowance therefore already compensates DNSPs for the early refinancing costs that would be incurred under the Underwriting Method, and accordingly any recovery for early refinancing costs would be double-counting the costs of managing refinancing risk.

4. CitiPower and Powercor Australia's response to the AER's Draft Determination

In their Revised Regulatory Proposals, CitiPower and Powercor Australia did not accept the AER's position in the Draft Determination. CitiPower and Powercor Australia proposed that the appropriate allowance for debt raising costs is a total of 24.6 bppa, which is made up of direct debt raising costs of 9.1 bppa and early refinancing costs of 15.5 bppa.

4.1 CitiPower and Powercor Australia's proposed early refinancing costs

4.1.1 The prudent and efficient amount of early refinancing costs

CitiPower and Powercor Australia propose that the AER should include an allowance for early refinancing costs that is equal to the average of the Completion Method with no buyback and a Committed Bank Loan Facility.

Based on the averaging period of 1 March to 19 March that the AER used in the Draft Determination, CitiPower and Powercor Australia's proposed method results in an allowance for early refinancing costs of 15.5 bppa. This amount should be recalculated by the AER using CitiPower and Powercor Australia's agreed averaging period prior to the Final Determination.

In deciding whether to accept CitiPower and Powercor Australia's operating expenditure forecasts for early refinancing costs, the test that the AER must apply is that set out in clause 6.5.6(c) of the Rules, as discussed above. The AER may only reject CitiPower and Powercor Australia's forecasts if it is not satisfied that they reasonably reflect the operating expenditure criteria, and if it does so the AER may only amend those forecasts to the extent necessary so that they reasonably reflect the operating expenditure criteria.

Ms Williams' witness statement demonstrates that CitiPower and Powercor Australia's proposed amount of early refinancing costs is efficient and is the minimum amount that a

⁶ AER, Draft Determination Appendices, Appendix P, p345.

⁷ AER, Draft Determination Appendices, Appendix P, pp343-345.

⁸ The Allen Consulting Group, Debt and Equity Raising Costs, Report to the Australian Competition and Consumer Commission, Final Report, December 2004 (**ACG Report**).

⁹ PricewaterhouseCoopers, ETSA Utilities: Distribution network service provider refinancing costs: Final Report, February 2010 (**PwC Report**).

prudent operator in CitiPower and Powercor Australia's circumstances would require to achieve the operating expenditure objectives.

Indeed, CitiPower and Powercor Australia consider that their proposal results in a conservative estimate of the prudent and efficient early refinancing costs because it only allows for refinancing 3 months prior to maturity. Table 1 in Ms Williams' witness statement demonstrates that most comparable firms refinance their debt significantly more than 3 months prior to maturity. In addition, CitiPower and Powercor Australia's own policies require them to refinance at least 6 months prior to maturity.

In the South Australian Final Determination, the AER stated:¹⁰

'The opex of the benchmark firm is assessed with regard to prudence, as required by clause 6.5.6 of the NER. The AER considers that if the close comparators to the benchmark firm are observed to undertake a particular action, this supports the conclusion that such an action is prudent. The AER notes that Handley made a similar assessment.'

The AER made a similar comment in the Draft Determination, as noted above.¹¹

CitiPower and Powercor Australia agree that if a significant number of close comparator firms take similar actions to manage refinancing risk then that is strong evidence that such actions are prudent and that a prudent firm in CitiPower and Powercor Australia's circumstances would incur the costs of taking those actions. The summary of the actions of close comparator firms set out in Table 1 of Ms Williams' witness statement therefore provides strong evidence that CitiPower and Powercor Australia's proposed early refinancing costs reasonably reflects the operating expenditure criteria under clause 6.5.6(c) of the Rules and those costs should be included in CitiPower and Powercor Australia's operating expenditure forecasts.

4.1.2 This allowance for early refinancing costs is not already included in the direct debt raising costs

This proposed amount of early refinancing costs should be provided in addition to the allowance for direct debt raising costs

In the Draft Determination, the AER concluded that:¹²

- the most efficient method of managing early refinancing risk was the Underwriting Method;
- the costs of the Underwriting Method were already included in the gross underwriting costs component of the direct debt raising costs; and
- accordingly, an additional allowance for early refinancing costs was not appropriate because it would result in double-counting.

Ms Williams' witness statement explains that:

- to be a prudent method of managing refinancing risk that would be adopted by a benchmark firm, the Underwriting Method must provide underwriting cover for a period of at least three months;

¹⁰ AER, South Australian Final Determination, p 373.

¹¹ AER, Draft Determination Appendices, Appendix P, p340.

¹² AER, Draft Determination Appendices, Appendix P, pp343-345.

- underwriters do not provide underwriting cover for a period of three months in relation to Australian capital markets transactions, and accordingly the Underwriting Method is not a method that could be adopted by a prudent operator to manage its refinancing risk;
- the bond issues that the AER considered when calculating the gross underwriting costs component of the direct debt raising costs only involved book build underwriting for a period of 3 to 7 days;
- this book build underwriting does not reduce a firm's refinancing risk and would not be adopted by a prudent operator to manage its refinancing risk; and
- the gross underwriting costs component of the direct debt raising costs only covers the establishment fee of the bond issue and does not include any allowance for early refinancing costs.

Accordingly, CitiPower and Powercor Australia consider that the AER's conclusions are incorrect and a separate allowance for early refinancing costs is required in addition to the standard allowance for direct debt raising costs.

Ms Williams' witness statement also explains that underwriting for a period of three months is not available for Australian capital market debt transactions. That point also demonstrates that the Draft Determination is incorrect in reaching the conclusion that the gross underwriting costs that are included in the direct debt raising costs allowance covers the costs that a prudent firm would incur in obtaining three months underwriting to manage refinancing risk. If an underwriter would not provide underwriting cover for a period of three months due to the very high level of risk involved, it is not possible that the costs of such underwriting are included in the standard debt raising costs that are incurred for every bond issue.

In the Draft Determination, the AER states that the terms of reference for the PwC Report do not make any reference to excluding costs that are already included in the direct debt raising costs allowance.¹³ However, several comments in the PwC Report make it clear that PwC's estimate of the costs of the Underwriting Method are in addition to the direct debt raising costs that would be incurred in all bond issues.

- In its definition of the Underwriting Method, PwC states that the costs incurred in this method are the underwriting costs of the bond agent bank '*[r]ecognising that the underwriting fees are in addition to fees Bond Agent[s] normally charge on a non-underwritten bond transaction*'.¹⁴ The PwC Report defines the Underwriting Method as underwriting for a period of three months and it is clear that PwC's reference to a 'non-underwritten bond transaction' means a standard bond transaction with 'book build' underwriting but without underwriting for a three month period. It is therefore clear that PwC has based its calculations on additional costs that would be incurred on top of the direct debt raising costs.
- In its detailed description of the Underwriting Method, PwC states:

*'Underwritten bond transactions are customarily expensive. As a 3 months underwriting timeframe is regarded longer than normal, this refinancing option would be difficult to obtain from banks, and would be regarded the most expensive and not be commonly utilised by borrowers.'*¹⁵

¹³ AER, Draft Determination Appendices, Appendix P, p343.

¹⁴ PricewaterhouseCoopers, ETSA Utilities: Distribution network service provider refinancing costs: Final Report, February 2010, p9.

¹⁵ PricewaterhouseCoopers, ETSA Utilities: Distribution network service provider refinancing costs: Final Report, February 2010, p20.

It is clear from this statement that PwC considers that the form of underwriting that it has costed for the Underwriting Method is not something that is offered by banks as standard and is not included in the standard direct costs of a bond issue. It is inconceivable that PwC would have made this statement if it considered that the costs of a three month underwriting were included in the direct debt raising costs that are incurred in relation to every bond issue.

In the Draft Determination, the AER states that because the ACG Report on which the estimate of direct debt raising costs was based was a comprehensive report, it is reasonable to assume that it considered early refinancing costs.¹⁶ However, there is no evidence to support that assertion. Nothing in the ACG Report suggests that ACG considered early refinancing costs or that ACG's estimates of underwriting costs were based on underwriting for a period of three months. On the contrary, Ms Williams' witness statement demonstrates that ACG's underwriting costs were only based on the 'book build' form of underwriting and did not include any allowance for the costs of a method that would be adopted by a prudent firm to manage refinancing risks.

The AER was therefore incorrect to conclude that the early refinancing costs that would be incurred by a prudent operator are already included in the direct debt raising costs. The early refinancing costs that would be incurred by a prudent operator to manage its refinancing risk to a prudent extent are additional costs that are not included in the AER's allowance for direct debt raising costs.

4.2 CitiPower and Powercor Australia's proposed direct debt raising costs

In the Draft Determination, the AER allowed direct debt raising costs of between 9.0 and 10.8 bppa, depending on the number of bond issues undertaken by the DNSP.¹⁷ In the AER's Post Tax Revenue Models, the AER allowed 9.1 bppa for Powercor Australia and 9.3 bppa for CitiPower.

CitiPower and Powercor Australia accept the amount of direct debt raising costs set out in the Draft Determination, ie 9.1 bppa for Powercor Australia and 9.3 bppa for CitiPower. However, as explained above, CitiPower and Powercor Australia do not agree that this amount of direct debt raising costs includes an allowance for early refinancing costs. The proposed allowance of 15.5 bppa for early refinancing costs should be added to this allowance for direct debt raising costs.

CitiPower's Revised Regulatory Proposal contains an inadvertent error in relation to the amount of direct debt raising costs. CitiPower's Revised Regulatory Proposal stated that CitiPower proposes an allowance of 24.6 bppa for debt raising costs, which is made up of direct debt raising costs of 9.1 bppa and early refinancing costs of 15.5 bppa.¹⁸ This was an error and the correct figure for direct debt raising costs should be 9.3 bppa, as set out in the AER's Post Tax Revenue Model for CitiPower.

CitiPower's total proposed debt raising costs should therefore be 24.8 bppa.

The correction of this error requires a very small change to CitiPower's Annual Revenue Requirements and 2011 X factor.

Appendix 1 to this submission contains updated versions of Tables 6.4, 18.3 and 18.4 of CitiPower's Revised Regulatory Proposal reflecting this corrected debt raising costs figure.

¹⁶ AER, Draft Determination Appendices, Appendix P, pp343-344.

¹⁷ AER, Draft Determination Appendices, Appendix P, p337.

¹⁸ CitiPower, Revised Regulatory Proposal, p186.

Appendix 1: Corrected versions of Tables to CitiPower's Revised Regulatory Proposal

The following tables replace the tables contained in CitiPower's Revised Regulatory Proposal dated 21 July 2010.

	\$'000 (real 2010)					
	2011	2012	2013	2014	2015	Total
Debt raising costs	1,868	2,041	2,218	2,412	2,589	11,128

Table 6.4 Debt raising costs

	\$m (nominal)				
Building block	2011	2012	2013	2014	2015
Indexation of the RAB	(33.1)	(37.1)	(41.3)	(46.1)	(50.8)
Return on capital	132.6	148.6	165.6	184.7	203.4
Depreciation	67.9	75.7	84.0	93.0	103.2
Operating expenditure	52.7	54.4	57.6	59.2	63.4
Corporate income tax	4.2	4.6	5.5	5.9	6.9
Efficiency carryover	0.0	0.0	0.0	0.0	0.0
Service incentive scheme	0.2	(2.9)	(3.4)	(0.2)	(7.3)
Total revenue requirement	224.4	243.4	267.9	296.4	318.8

Table 18.4 Proposed ARRs

	2011	2012	2013	2014	2015
X factors (%)	-7.22%	-4.00%	-4.00%	-4.00%	-4.00%

Table 18.5 Proposed X factors