Estimating the allowed return on debt discussion paper

QUEENSLAND TREASURY CORPORATION

SUBMISSION TO THE AUSTRALIAN ENERGY REGULATOR – MAY 2018

Summary

Queensland Treasury Corporation (QTC) welcomes the opportunity to provide comments on the Australian Energy Regulator's (AER) *Estimating the Allowed Return on Debt Discussion Paper*. Our main comments are as follows:

- QTC supports the continued use of a 10-year tenor to determine the benchmark debt yield:
  - A first principles approach based on the characteristics of the benchmark efficient entity (BEE) and well-established financial risk management principles supports a benchmark tenor of at least 10 years. A 10-year tenor is a pragmatic choice based on the practical constraints faced by borrowers in the Australian market.
  - The benchmark tenor was extensively tested in the AER's 2009 weighted average cost of capital (WACC) review, the Australian Energy Market Commission's (AEMC) rule change consultation process, and the development of the current Rate of Return Guideline. On each occasion it was determined that a 10-year tenor was appropriate.
  - A 10-year tenor provides correct incentives for service providers to prudently manage refinancing risk. It also provides some compensation for the costs associated with higher refinancing risk when longer-term debt is temporarily unavailable, such as the 2008 global financial crisis.
  - Most service providers have already started changing their debt portfolios based on the AER's 10-year transition to a full trailing average. Changing the benchmark tenor will require a new transition to be developed and agreed. This adds complexity to an already contentious issue and is inconsistent with regulatory stability.
- The analysis performed by Chairmont does not support changing the current 10-year benchmark debt tenor:
  - Chairmont's sample includes debt issues associated with the privatisations of network businesses in New South Wales. The average issue tenor required to establish a portfolio that matches the trailing average approach is much shorter than the issue tenor required to maintain a portfolio that matches the trailing average approach.
  - Chairmont's analysis is limited to debt issues by firms that are regulated by the AER. In QTC's view it is more appropriate to consider debt maturity profiles, including the profiles of broadly comparable unregulated firms.
- The benchmark debt yield should continue to be estimated by giving equal weight to corporate yield estimates from the Reserve Bank of Australia (RBA) and Bloomberg. Both estimates broadly move together over time and there is no evidence to suggest that either series is systematically biased upwards or downwards over the long-term.
  - To the extent that unbiased estimation errors exist they will have a negligible impact under a 10-year trailing average approach as each observation only receives a 10 per cent weight in the allowed return on debt.
  - The Discussion Paper notes that the yield estimates produced by Standard & Poor's (S&P) have been materially and consistently lower than the simple average of the RBA and Bloomberg estimates. This may indicate a systematic downward bias, which makes the S&P series unsuitable for estimating the benchmark debt yield.

Benchmark debt tenor

1.1 First principles approach

- It is generally accepted that the most prudent way to manage refinancing risk is by maintaining a staggered maturity profile out to a sufficiently long maximum debt tenor. The AER's decision to adopt a 10-year trailing average return on debt approach is consistent with this view.
- A first principles approach based on the characteristics of the BEE and well-established financial risk management principles supports a benchmark tenor of at least 10 years. The characteristics of the BEE that are relevant to the benchmark debt tenor are as follows:
  - Maintain 60 per cent gearing, which is significantly higher than the average gearing for market listed firms.
  - Maintain an investment-grade credit rating of BBB+[1].
  - Operate in a capital intensive industry with very long-lived assets (eg, 50–60 years).
- There is a strong relationship between the first two characteristics. Maintaining an investment grade credit rating when gearing is high requires the BEE to have a relatively small annual refinancing task. This requires maintaining a staggered maturity profile out to a relatively long maximum debt tenor.
- The third characteristic suggests that (in theory) the average debt issue tenor should be relatively close to the useful life of the underlying assets. This supports a benchmark debt tenor that is significantly longer than 10 years.
- In practice, there are constraints on the maximum debt tenor that can be regularly achieved in the Australian corporate bond market. As such, a 10-year tenor can be viewed as a pragmatic choice based on the practical constraints faced by service providers when managing refinancing risk.

1.2 Outcomes from previous reviews

- The benchmark debt tenor was extensively tested in the AER's 2009 WACC review, the AEMC's rule change consultation process, and the development of the current Rate of Return Guideline.
- These reviews involved an analysis of the debt maturity profiles of regulated and unregulated firms, and the application of a first principles approach similar to the one set out above.
- On each occasion it was determined that a 10-year benchmark tenor was appropriate. In QTC's view no evidence has been provided since these reviews to justify a change to the benchmark debt tenor.
- During the AEMC's rule change consultation it was noted that debt issue tenors were significantly shorter than 10 years around the time of the global financial crisis in 2008. This was due to the long-term corporate bond market effectively closing, which forced service providers to place greater reliance on shorter-term debt.
- During periods such as this the additional margin from a 10-year return on debt allowance provides some buffer against the increased costs of managing refinancing risk. For example, consider a service provider that has maintained a staggered maturity profile with equal amounts of debt with remaining tenors of 1–10 years:
  - If the service provider can only issue 5-year debt to refinance a maturing borrowing (which equals 10 per cent of total debt), this will increase this size of the refinancing task in 5 years time to 20 per cent of total debt.
  - To reduce refinancing risk it would be appropriate for the service provider to pre-issue new debt well ahead of the scheduled maturity in 5 years time and invest the proceeds in a risk-free asset until required. The additional margin from the 10-year return on debt allowance can be used to offset the negative interest rate differential between the pre-issued debt and the risk-free investment[2].
- In QTC's view, a 10-year benchmark debt tenor provides:
  - correct incentives for service providers to prudently manage refinancing risk by issuing long-term debt, and
  - some compensation for the costs associated with higher refinancing risk when longer-term debt is temporarily unavailable.

[1] An investment grade credit rating is equal to or higher than BBB- (S&P) or Baa3 (Moody's).

[2] A more detailed analysis of this issue can be found in QTC's April 2012 submission to the AEMC's Directions Paper in relation to the Economic Regulation of Network Service Providers rule change proposals (pp. 8–19).

1.3 Trailing average transition

- Most service providers have already started changing their debt portfolios based on the AER's 10-year transition to a full trailing average. The required transactions will vary based on the debt management strategy adopted by the service provider under the previous on-the-day return on debt approach.
- Changing the benchmark debt tenor will require a new set of transitional arrangements to be developed and agreed. This will require yet another round of consultation with consumers and service providers on an issue that has proved to be highly contentious in the past.
- The current 10-year transition should be left to run its full course. This requires maintaining a 10-year benchmark debt tenor.

2 Chairmont analysis

- Chairmont was engaged by the AER to analyse the debt issuance performed by service providers between 1 January 2013 and 31 December 2017.
- The data includes debt issues associated with the privatisations of network businesses in New South Wales. These transactions are likely to reflect the one-off establishment of a portfolio that matches the trailing average approach:
  - *Establishing* a matching portfolio requires issuing equal amounts of fixed rate debt with initial tenors of 1–10 years. The average issue tenor for establishing the portfolio is 5.5 years.
  - *Maintaining* a matching portfolio requires refinancing each maturing debt with new 10-year debt. These are the transactions that are relevant to the benchmark debt tenor.
- Chairmont's analysis is limited to debt issues by firms that are regulated by the AER[3]. In QTC's view it is more appropriate to consider debt maturity profiles, including the profiles of broadly comparable unregulated firms[4].
- Appendix A shows the debt maturity profiles of a sample of unregulated firms. Maintaining these profiles will require the regular issuance of debt with an average tenor of at least 10 years.
- The Discussion Paper identifies other issues that make it difficult to draw conclusions from Chairmont's analysis, such as the timing of relevant determinations and the time taken to resolve appeals of the AER's return on debt transition, which may have affected the debt management strategies of some service providers[5].
- Based on these considerations, QTC does not believe that Chairmont's analysis justifies a change to the current 10-year benchmark debt tenor.

3 Estimating the benchmark debt yield

- QTC supports the AER's current approach of giving equal weight to the corporate yield estimates from the RBA and Bloomberg. Both estimates broadly move together over time (Figure 1), and there is no evidence to suggest that either series is systematically biased upwards or downwards over the long-term:

[3] QTC notes the recent Tribunal decision which concluded that the BEE should not be assumed to be a regulated or unregulated firm.

[4] This would include firms that operate in capital intensive industries and/or maintain relatively high gearing.

[5] Discussion Paper, p. 33.

FIGURE 1: RBA AND BLOOMBERG CORPORATE YIELD ESTIMATES

- To the extent that unbiased estimation errors exist they will have a negligible impact under a 10-year trailing average approach as each observation only receives a 10 per cent weight in the allowed return on debt.
- The Discussion Paper notes that the yield estimates produced by S&P have been materially and consistently lower than the simple average of the RBA and Bloomberg estimates. This may indicate a systematic downward bias, which makes the S&P series unsuitable for estimating the benchmark debt yield.

Appendix A: Debt maturity profiles of unregulated firms

FIGURE 2: TELSTRA CORPORATION

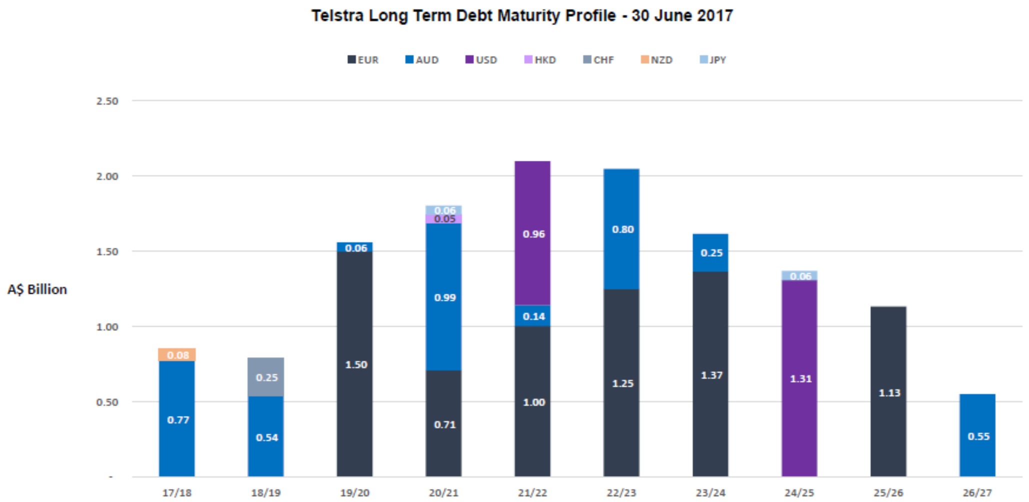


FIGURE 3: SYDNEY AIRPORT CORPORATION

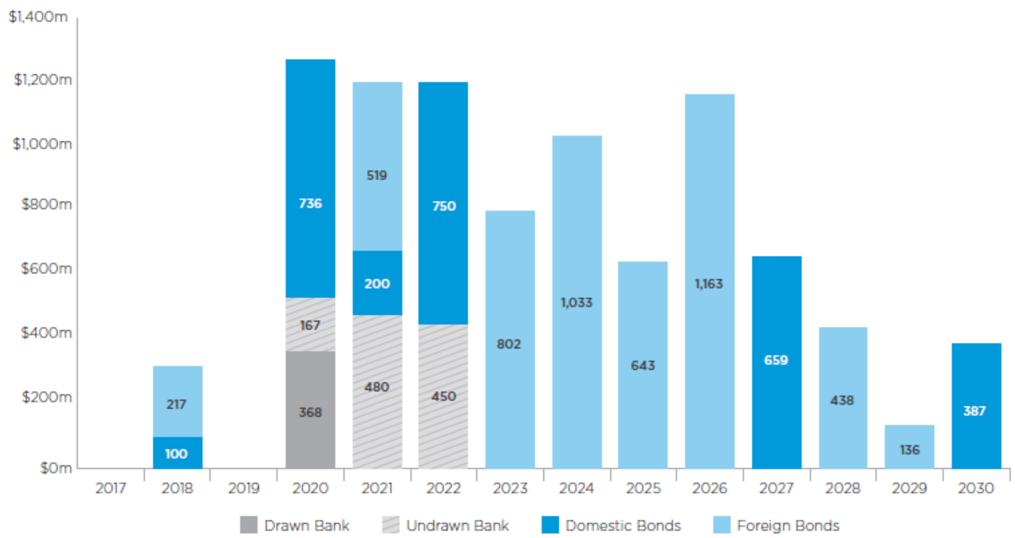
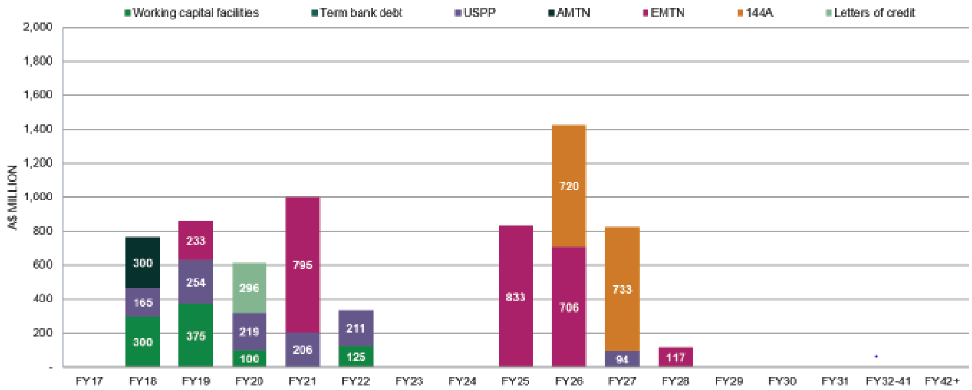


FIGURE 4: TRANSURBAN

Corporate debt maturity profile



Non-recourse debt maturity profile

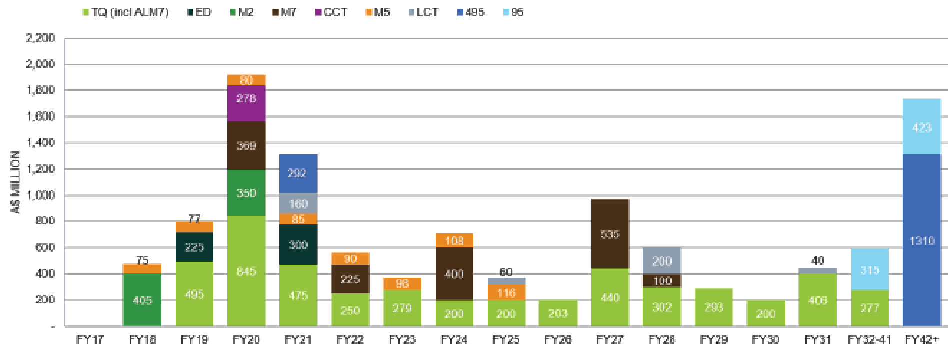


FIGURE 5: RIO TINTO