Use of industry debt data

Hird presentation to expert conclave

February 2022

What should the AER attempt to do?

In my view, the appropriate decision process for the AER is to sequentially make the following decisions:

Decision 1: Define an efficient benchmark debt strategy.

2018 RoRI answer: A 10-year trailing average at 60% gearing is the 2018.

Decision 2: Determine a method for accurately estimating the cost to NSPs of implementing that efficient benchmark debt strategy.

2018 RoRI answer: Average of RBA/BB/Reuters BBB+ 10-year yields

How can industry debt data inform these decisions?

Industry debt data can be used to inform both these decisions. But is should no be used outside this framework.

Uses of industry debt data	Valid?
To inform Decision 1 (What is the benchmark strategy?)	✓
To inform Decision 2 (What is the cost of the benchmark strategy?)	✓
To target compensation to some measure of industry average costs (“the EICSI”) – even if “the EICSI” is not constructed consistently with the “benchmark strategy” determined in Decision 1.	✗

How did the 2018 RoRI use industry debt data?

The approach in the 2018 RoRI generally used industry debt data in a valid way to make the two relevant decisions.

Use of industry debt data in 2018 RoRI	Valid?
2018 Decision 1: Benchmark strategy of staggered issuance of 10-year debt and the maintenance of a 60% gearing rate. **Informed by NSP data:** which showed this strategy was consistent with the observed practice of many, but not all, NSPs.	✓
2018 Decision 2: That the costs to NSPs pursuing the strategy defined in Decision 1 could be accurately measured by averaging of RBA/Reuters/Bloomberg estimates of BBB+ 10-year cost estimates. **Informed by NSP data:** that showed credit spreads very similar to those estimated by averaging of RBA/Reuters/Bloomberg estimates of BBB+ credit spreads at the relevant tenor of each NSP instrument.	✓

How does the November 2021 final working paper propose to use industry debt data

The November 2021 paper has moved away from an approach of targeting compensation to “the EICSI”. Now the objective, like the approach in the 2018 RoRI, is described as follows.

> *Conceptually, we think we ought to use the EICSI to adjust our return on debt approach to remove any residual outperformance that is material and persistent. In this context ‘residual outperformance’ refers to the ability of the regulated networks to raise debt at a lower rate (**for a given term and credit rating**) than the broader market that is represented in the third-party debt yield curves we use in determining our return on debt benchmark. (p.70)*

This analysis is informative to Decision 2. ✓

That said, other forms of analysis can also be informative (e.g., restricting instruments in the EICSI to those already similar to the benchmark).

What residual outperformance exists?

The November 2021 paper concludes that there is a 4bp average outperformance from January 2014 to July 2021 (7.5 years).

My own analysis (using a similar but different method) estimates similar results. I estimate negative outperformance of -1bp (tenor weighted) over the last 7 years while the AER estimate is +4bp over the last 7.5 years.

When value weighted, the outperformance is always negative.

Table A: Average outperformance (bp) relative to matched credit rating and to matched term (subordinated debt excluded)

Years of data to 30 June 2021	1	2	4	6	7
Tenor and value weighted	-17	-11	-8	-2	-11
Tenor weighted	-10	-4	-5	3	-1

What is the average tenor (WATMI)?

The November 2021 paper concludes the WATMI is between 8 and 10-11 years (p.85)

My own analysis estimates similar results. Depending on inclusions, the all firms WATMI at 30 June 2021 sits between 9.5 and 10.7 years.

	30-Jun-18	30-Jun-19	30-Jun-20	30-Jun-21
Excluding subordinated debt				
All firms	9.1	9.2	9.2	9.5
NSW firms excluded	9.8	9.8	9.9	10.2
Including subordinated debt				
All firms	9.5	9.5	9.6	10.7
NSW firms excluded	10.4	10.3	10.4	11.9

How does this analysis inform Decisions 1 and 2?

In my view, the analysis of the industry debt data (both mine and that presented in the November 2021 final working paper), supports:

Decision 1: Maintain the benchmark efficient debt strategy determined in the 2018 RoRI; and

Decision 2: Maintain the method for estimating the cost of the benchmark strategy determined in the 2018 RoRI.