Summary of the views of Tom Hird on use of "the EICSI"

AER questions

AER's industry debt index (EICSI)
Questions for the session:
- o What role should our debt index (EICSI) take in the rate of return instrument?
- o Our analysis has indicated that there has been some outperformance of our return on debt. Is the outperformance such as to require an adjustment to our return on debt?
- o Should the EICSI (and resulting WATMI) be used to inform the term for the return on debt? And if so, how?

Summary of opinion

It is critical to define two distinct decisions a regulator must make when determining the cost of debt.

Decision 1: Define a unique benchmark efficient debt strategy ("benchmark strategy"); and

Decision 2: Having defined a unique "benchmark strategy", determine a method for accurately estimating the cost to NSPs of implementing that "benchmark strategy".

I summarise how I consider industry debt data should, and should not, be used.

Use of industry debt data	Valid?
To inform Decision 1	✓
To inform Decision 2	✓
To target compensation to "the EICSI" – even if "the EICSI" does not reflect the cost of implementing the "benchmark strategy" determined in Decision 1.	✗

The November 2021 final working paper analysis appear to me to be generally consistent with valid uses of industry debt data.

Valid use of industry debt data – compensation and tenor

The 2018 RORI can be used to make these concepts concrete.

Use of industry debt data	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.	✓

The AER's analysis of 2021 data is broadly consistent with its 2018 analysis. Namely, that:

- a benchmark 10-year tenor is consistent with many, although not all, NSP's practices; and
- tenor matched credit spreads are similar to RBA/Reuters/Bloomberg estimates of BBB+ credit spreads (4bp lower on average).

On this basis, it would be valid use of NSP data for the AER to conclude that its 2018 Decisions 1 and 2 remain appropriate (in particular, 10-year tenor and BBB+ compensation).

That does not mean that the AER must retain a 10-year tenor (other higher/lower tenors are also arguably consistent with NSP practices). However, any change would need to balance a number of considerations, including:[1] a) NSP exposure to refinance risk; b) the level of risk customers face (noting that lower benchmark tenor implies a shorter, and therefore more volatile, trailing average cost of debt); c) lower levels of compensation/costs (as shorter tenors typically have lower costs); and d) complexity of transitions between benchmark tenors.

However, changing the benchmark tenor is the only valid way to target compensation to a tenor lower than 10-years. It would be invalid to use of the EICSI as a "back door" way of targeting a lower tenor.

Invalid use of the EICSI

I am concerned about some aspects of the construction of the EICSI (e.g., the absence of value weighting). However, even if the EICSI perfectly measured average industry costs it would still be:

- Invalid to target compensation to the EICSI; rather than
- Targeting compensation to the cost of the benchmark strategy decided in Decision 1.

This is because the EICSI ultimately reflects a weighted measure (dependent on its construction) of industry average debt strategies. This will not generally align with the benchmark strategy determined in Decision 1. Targeting compensation to an implied debt strategy that is different from the explicit benchmark strategy would create serious internal inconsistencies.

Concretely, the AER reports that the EICSI has an average tenor of around 8 years.[2] Targeting a 10-year trailing average to the EICSI would be tantamount to populating the 10-year trailing average with the cost of 8-year instruments. NSPs who followed the benchmark 10-year strategy would be under-compensated for their costs and all NSPs (even those who followed an 8-year strategy) would be unable to hedge to the regulatory benchmark. There would also be mismatch between the payments customers make (based on an 8-year cost of debt) and the level of risk/volatility that they bear (based on a 10-year trailing average).

The November 2021 final working paper is alive to these problems. The paper restricts the definition of "outperformance" to "*the residual outperformance margin that is evident after accounting for differences in term and credit rating*".[3] This, in my view correctly, attempts to ensure that any measured "outperformance" can be related back to the benchmark strategy (e.g., is not picking up the impact of some NSPs departing from that benchmark strategy).

Adjusting for outperformance

The final working paper reports a matched term (i.e., adjusted for tenor) outperformance of just 4 bppa.[4] Given the uncertainty inherent in such measurement, I consider that this implies no meaningful outperformance and, therefore, no requirement to adjust for that outperformance.

The paper does propose exploring placing a cap on the level of compensation for credit risk (based on analysis that suggests most outperformance occurs in periods of high measured credit spreads).[5] I do not see utility in such an exploration given no meaningful overall estimate of outperformance.

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1 The AER discusses some of these considerations on p.85 of its Final working paper | November 2021.

2 Ibid, Figure 4, p. 70 and also last paragraph on p.78.

3 Ibid, p. 71 and p.84. See also discussion on p.86 where the AER explains that it does not consider changing the credit rating compensation is based on would be an appropriate way to remove "outperformance" that is due to lower than benchmark tenor.

4 Ibid p. 78.

5 Ibid p. 83.