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Australian Energy Market Commission
Via online submission at www.aemc.gov.au

ERC0134 – Cost of Debt Issues

The Australian Pipeline Industry Association (APIA) welcomes the opportunity to make a submission to the AEMC's additional consultation paper on Cost of Debt issues and the proposal raised by Queensland Treasury Corporation (QTC).

Approach to Cost of Debt
Before responding to the specific questions raised by the AEMC, APIA would like to provide some more general comments on the approach that should be taken to achieve a robust Cost of Debt component in the overall rate of return determination.

As highlighted in previous APIA submissions and direct discussions with the AEMC, APIA considers that achievement of the best rate of return requires consideration of multiple sources of evidence. Individual pieces of evidence can be determined by formula, market data and benchmarks or other sound sources. Weight should be given to each piece of evidence based on consideration of its strengths and weaknesses, its quality and its statistical significance. This view is consistent with the advice provided to the AEMC by SFG Consulting and the position taken by the AEMC in its Directions Paper.

As addressed in APIA's submission to the AEMC's Direction Paper (p18), in regards to the Cost of Debt APIA considers the best approach in determining an appropriate value which achieves an outcome consistent with prevailing conditions in the market for funds is one that takes a forward looking independent estimate using relevant and available market based evidence. That is, use of an expert market service to estimate[1] the cost of debt has significant advantages over "do-it-yourself" estimates, including the fact that such a service is being provided all the time and has been provided for many years, employs professional expertise, uses a wide source of market data, has wide market acceptance the service. The validity of the estimates from such services can be tested.

[1] APIA does not recommend that the use of a particular market service be written into the Rules.

To undertake a rigorous “do-it-yourself” estimate requires the use of all the available data to which statistically valid curve fitting can be applied. Taking a sample limited to around 5 - 10 years throws away relevant data and runs the risk of the sample not being reflective of market conditions.

In APIA’s view it is essential that the cost of debt not depart from using a forward looking cost of capital. The rate of return is forward looking for three reasons:

- because economically efficient investment is served by determining a rate of return, including the return on debt, that best reflects the cost of capital at the time when the investment will occur and not that which applied in the past;
- because the regulatory process is concerned with setting prices for the next five (or more) years. This means by nature, every cost determined by an access arrangement review or a pricing and revenue determination is a forecast. Therefore all of the variables including the rate of return are a forecast for the next five years. A historical trailing average cannot substitute as a better forecast than market derived forecast evidenced by the yield curves for appropriately graded debt; and
- investors require a forward looking rate of return that includes a forward looking return on debt.

The proposals by QTC and others should be considered in this light. APIA does not consider QTC’s proposal preferable to the approach described above, but accepts it may be useful to have as an option for service providers to consider. It is on this basis that the following comments are provided.

Response to Questions

1. What are the advantages and disadvantages of QTC’s proposal?

Advantages:

- Apart from the initial transition, there is no need to hedge the entire debt portfolio during one hedging program. It would be more practical to hedge 10% of the debt portfolio every year.
- A yearly cost of debt calculation could remove some uncertainty regarding debt refinancing margins and the timing of interest rate hedging programs to align with regulatory decisions.
- Assuming longer term debt is in place, the resultant swap book maturities may be more closely aligned to the underlying debt maturity profile and provide some flexibility to adjust hedge cover on an annual basis.

Disadvantages:

- The proposal assumes that debt is fully hedged, which does not provide the required flexibility to manage an entity’s capital structure efficiently. The proposal has not outlined the methodology for determining the cost of debt on any floating interest rate exposures. Unless addressed this would lead to a mismatch between the floating rate paid (90 day BBSW) and a cost of debt based on the 10yr swap rate.
- The choice of appropriate benchmarks and calculation detail need to remain flexible (eg. 10yr swap rates and debt margins) and the cost of debt should be required to include fees such as credit spreads above the prevailing swap rate. This will become more important with the implementation of the Basel III standards imposing greater capital requirements (and therefore credit charges) on swap banks.

- Significant changes to risk management processes that would be require financier consents and changes to internal policy and procedures.

2. If QTC's proposal was to be implemented, how would such a move affect a NSP's current financing practices? What impact would it have on its risk management practices?
Whilst financing practices are largely driven by prevailing financial market conditions, the moving average proposed may encourage a smoother, more efficient debt maturity profile, rather than grouping debt maturities around regulatory reset decisions for single-asset businesses.

Under this proposal, risk management practices of single-asset businesses are likely to change significantly both upon transition and on an ongoing basis.

3. Would QTC's approach reduce the overall level of risk associated with debt financing for NSPs? If so, are there any implications for cost of equity?
Whilst there may be some merit in the QTC proposal for some NSPs or gas service providers, inherent risk remains that are associated with timing of the debt financing and the regulatory process. More generally, any one-size fits all approaches will never deliver the required flexibility within the NEL/NGL regimes to deliver desired outcomes. Any implications for the cost of equity would be very difficult to quantify.

4. What changes (if any) should be made to the approach to calculation of the cost of equity if this moving average approach is applied to debt to ensure a consistency of approach?
It is difficult to predict if adopting the QTC proposal will result in a change in the cost of equity either through a reduction in overall systematic risk or a transfer of risk from debt holders to equity holders. APIA is of the view that to the extent that there is any change it is not likely to be easily measured. Whether this is true or not the current methodologies for estimating the cost of equity – ie using the various forms of CAPM or the dividend growth model – are just as valid and would not be changed as a result of adopting the QTC cost of debt approach.

5. If the moving average approach is adopted, should the average be calculated based on dollar-weighted average of the rates or by calculating the effective interest rate (the IRR of all future payments on the debt) or some other method?
Were this approach to be allowed, APIA would be inclined to prefer the use of the dollar-weighted average as this better represents the actual cost of debt each year.

6. Is the proposal for re-calculating the cost of debt on a quarterly basis reasonable? What other frequency of data points (to the proposed quarterly basis) could be used in calculating the cost of debt and why would this be an improvement?
APIA does not see that it would be necessary to recalculate the cost of debt quarterly. An annual basis would be sufficient to align with each update to the cost of debt. Furthermore, it is appropriate that a base rate (eg. 10yr swap rate) be chosen that aligns with the cashflows/interest periods of the benchmark business.

7. Should this approach be an option under the rules? If so, should the regulator or the NSP have the discretion to exercise the option and why?

APIA does not consider the QTC's proposal preferable to an approach which employs a forward looking cost of debt that reflects prevailing in the market for funds. Therefore any optionality on applying this approach should rest with the NSP or service provider.

If the AEMC would like any more information in regards to the comments above, please contact me on (02) 6273 0577 or at sdavies@apia.asn.au.

Yours sincerely

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