Cost of debt under a trailing average portfolio approach

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Overview

- Cost of debt - estimation and application
- Recent changes to the NER and NGR
- Trailing average portfolio approach
- AER's draft trailing average portfolio approach
- Relevance to the QCA's cost of capital review

Cost of debt – estimation and application

- Most of the focus has been on estimating the benchmark debt yield at a point in time
  - PwC's regression-based method
  - Paired bond extrapolation of the 7-year Bloomberg Fair Value yield (AER)
  - RBA credit margin estimates (new data series)
- Less attention given to ***how*** these estimates should be used to calculate the regulated cost of debt

Cost of debt – estimation and application

- The ‘on the day’ application:
  - Average benchmark debt yield during a 10 to 40 day averaging period
  - Locked in for the term of the regulatory period
  - Timing of the averaging period is important, especially for consumers
- Assumes that a regulated business can fully reset their total cost of debt during *each* averaging period
- Consider alternative applications such as longer-term averaging
  - Partial reset of the cost of debt each year based on prevailing yields

Recent changes to the NER and NGR

- Rule change request to the Australian Energy Market Commission (AEMC) by the Energy Users Rule Change Committee (EURCC)
- EURCC proposed a new method to calculate the cost of debt
  - Full reset every 5 years exposes consumers to interest rate volatility
  - A longer-term average of historical interest rates will produce a more stable cost of debt allowance
- Extensive consultation with stakeholders
- National Electricity Rules (NER) and National Gas Rules (NGR) changed to allow consideration of a ‘trailing average’ approach

Trailing average portfolio approach

- Benchmark debt portfolio with staggered maturity dates
  - 1/10th of total debt re-financed each year (assuming a 10-year debt tenor)
  - Portfolio cost = 10-year trailing average of the 10-year yield
- Consistent with the debt management practices of non-regulated infrastructure businesses with long-lived assets
  - Based on sound financial risk management principles
  - Staggering maturity dates is a prudent and efficient way to manage re-financing risk, especially when gearing is relatively high

Trailing average portfolio approach

- Produces a more stable cost of debt that is relatively insensitive to short-term volatility in interest rates
- Reduces the significance of non-systematic estimation errors in the benchmark debt yield
- Cost of debt is the outcome from following a prudent and efficient benchmark debt financing strategy
  - Not the product of regulatory design or arbitrary factors
- Length of the regulatory period is irrelevant

AER's *draft* trailing average approach

- Benchmark portfolio of fixed rate debt with annually spaced maturity dates out to 7 years (1/7th of total debt re-financed each year)
- Benchmark debt tenor of 7 years (previously 10 years)
- Increases in the benchmark debt balance compensated at historical 7-year benchmark debt yields (ie, an unweighted average)
- Cost of debt updated annually
- Transitional arrangement based on the average 7-year benchmark debt yield during the next averaging period
- RBA credit margin data should allow a 10-year benchmark debt tenor to be retained

Relevance to the QCA's review

- Widen the scope to consider different applications of the benchmark debt yield to determine the cost of debt
- Large amount of work already performed by the AEMC and AER
  - Broad stakeholder support for the trailing average portfolio approach
- Current 'on the day' application creates unnecessary volatility in the cost of debt allowance
  - Flows through to prices paid by consumers

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