

WESTERN AUSTRALIAN
TREASURY CORPORATION

FINANCIAL SOLUTIONS FOR THE BENEFIT OF ALL WESTERN AUSTRALIANS

Mr Richard Begley
Rate of Return Guidelines Review
Economic Regulation Authority
PO Box 8469
Perth BC, WA 6849
publicsubmissions@erawa.com.au

Dear Mr Begley,


RATES OF RETURN GUIDELINES REVIEW

We submit for your consideration in the *Rates of Return Guidelines Review* the attached submission from the Western Australian Treasury Corporation (WATC).

Following the Stakeholder Workshop on 7 November 2013 and the publication of a range of *Return on Debt* estimation approaches by the ERA's consultant, WATC's has assessed each of the approaches from the perspective of a regulated firm holding a very large debt portfolio (i.e., more than \$5 billion), with the intention of highlighting the challenges that such a firm would face in attempting to match the benchmark Return on Debt allowance.

While WATC has no stake in the outcomes of the ERA consultation and regulatory processes, the ERA may benefit from WATC's experience as a major issuer in these markets.

Yours sincerely


JOHN COLLINS
CHIEF EXECUTIVE OFFICER
14 November 2013

TONY DIXON
CHIEF ADVISOR
14 November 2013

Introduction

The ERA has released a report by Chairmont Consulting that assesses six estimation mechanisms for the Return on Debt allowance. The six options considered were:

- A. Current model – five-yearly resets using the bond yield approach
- B. Annual resets of the one-year swap base rate and five-yearly resets of a medium-term debt risk premium (DRP)
- C. Five-yearly reset of the five-year swap rate and annual resets of a medium-term DRP
- D. Annual resets with observed bond yields (i.e., a quasi-five-year rate)
- E. Trailing average
- F. Staggered maturities – various debt components with different debt tenors, but all debt ultimately refinances simultaneously at the five-year point.

The options were scored against various criteria that align with the National Gas Objective (NGO), which is as follows:

“The objective of this Law is to promote efficient investment in, and efficient operation and use of, natural gas services for the long term interests of consumers of natural gas with respect to price, quality, safety, reliability and security of supply of natural gas.”

The scoring of the options by Chairmont was a simple “Yes”, “No” or “Partially”, where a “No” score for any criteria invalidated the mechanism. The report findings were:¹

1. Options B and C are the best fit, because of the frequency of updates of prevailing rates;
2. Options D and E scored at least one “No”;
3. Option F does not score a “No” but does not provide any stronger outcomes than Options A, B and C;
4. A key decision criterion for determining the mechanism to be adopted is how quickly should movements in interest rates be reflected in the price of gas to consumers;
5. Staggered debt issuance is both an efficient and sound risk management practice;
6. The measurement approach to the DRP and swap rates should be re-examined; and
7. Consideration should be given to adding an adjustment factor for all on-the-day approaches.

The Allowed Rate of Return Objective (ARORO) as set out in the National Gas Rules 87(3) states that:

“the rate of return is to be commensurate with the efficient financing costs of a benchmark efficient entity with a similar degree of risk as that which applies to the service provider in the provision of reference services.”

In Section 1, the six Return on Debt allowance options are assessed from the perspective of a regulated firm with an extremely large debt portfolio (e.g., in excess of \$5 billion), highlighting in each case any difficulties the firm would face in attempting to match the benchmark. Section 2 specifically addresses the negative scores assigned to the trailing average by Chairmont. Section 3 briefly addresses the issue of ‘revenue certainty’, while Section 4 concludes the submission.

¹ Chairmont Consulting 2013, “Cost of Debt Comparative Analysis,” 5 November, p.3.

1. Market practicalities when managing the Return on Debt options

In principle, an 'efficient benchmark' should be replicable by the regulated firm; the regulator is incentivising firms to become more efficient, so it seems reasonable that firms should be capable of transitioning toward the benchmark. However, the ability of a firm to replicate the benchmark is dependent on the size of its debt portfolio. When managing a large volume of debt, the firm faces a number of market constraints forcing it to stagger its debt issuance and interest rate resets (if derivatives are used), with the result that the firm has debt with legacy interest rates that cannot be altered (without incurring valuation penalties) when the Return on Debt allowance is re-calculated. Chairmont Consulting emphasize that *"staggered debt issuance is both an efficient and sound risk management practice."*²

The following analysis explores the ERA's options from the perspective of firms with large debt portfolios (i.e., greater than \$5 billion).

Option A – The status quo

- The firm cannot refinance the entire debt portfolio over the 20-day regulatory reset window without incurring significant costs.
- Despite the greater depth of the swap market, the firm cannot swap an entire (floating) debt portfolio (to fixed rates) over the 20-day window due to the inability of the swap market to absorb large volumes at a few points on the curve over such a short time period. The excessive buy-side demand (receiving the fixed leg of the swap) at one point of the swap curve over such a short period will lead to higher prices (underlying swap rates).
- Lengthening the regulatory reset window as suggested by Chairmont, (e.g., to 60 days) would not resolve this problem.
- Accordingly, the benchmark is not replicable.
- The inability of the firm to align its actual debt costs with the Return on Debt allowance creates significant financial risk.
- Any attempt to reduce this financial risk by moving away from staggered issuance results in a less efficient financing structure with greater cost and/or greater risk, thereby not achieving the ARORO.

Option B – Annual update of (one-year) swap rate only + medium-term DRP

- The firm might consider issuing one-year debt, but it cannot refinance the entire debt portfolio over a 20-day window without incurring significant costs, or subjecting itself to an unacceptable degree of refinancing risk.
- The firm cannot swap an entire (floating) debt portfolio over the 20-day window due to the inability of the swap market to absorb large volumes at the one point on the curve over such a short time period.
- A rolling portfolio of floating rate notes (FRNs) with *annual* interest rate resets would be required to best replicate the benchmark. However, such an instrument is not traded in sufficient volumes required to facilitate efficient financing.
- Accordingly, this benchmark is not replicable.

² Chairmont Consulting 2013, "Cost of Debt Comparative Analysis," 5 November, p.3.

- To reduce financial risk, the firm would be incentivised to manage the revenue risk by issuing a series of staggered (unswapped) FRNs with shorter interest rate resets (e.g. 3-month or 6-month) that are actively traded.
- This Return on Debt allowance would lead to a volatile price outcome for consumers, which may not achieve the NGO.

Option C – Fixed (five-year) swap rate + annual reset of medium-term DRP

- The firm would not be able to alter its debt structure to align with an annually updating Return on Debt allowance.
- This benchmark is not replicable.
- This Return on Debt allowance would lead to a volatile price outcome for consumers, which may not achieve the NGO.

Option D – Annual updates of entire cost of debt

- This benchmark is not replicable as the firm could not annually update the interest rates of its debt to prevailing five-year rates (without incurring valuation gains/losses).
- To reduce financial risk, the firm would be incentivised to manage the revenue risk by issuing a series of staggered (unswapped) FRNs with shorter interest rate resets (e.g. 3-month or 6-month) that are actively traded. Such an approach would be expected, based on historical averages, to result in lower interest costs but would be subject to considerable basis risk dependent on the shape of the yield curve over the regulatory period.
- This Return on Debt allowance would also lead to a volatile price outcome for consumers, which may not align with the NGO.

Option E – Trailing average

- All refinancing and borrowing transactions for the benchmark firm are compensated at the prevailing cost of debt, rather than an historical average rate. That is, prevailing interest rates would be regularly incorporated into the annually-updated trailing average, giving appropriate economic signals for new capital investment.
- The benchmark is replicable in the sense that the Return on Debt allowance would broadly track actual efficient debt management practice; however, a trailing average will not provide certainty of cost recovery as it is calculated using benchmark interest rates and applied to benchmark debt balances (i.e., benchmark gearing (60%) x RAB) rather than the firm's actual debt balance. In practice, a firm will never exactly match the debt maturity profile of the trailing average portfolio, or exactly match the benchmark gearing, so there is little possibility that this mechanism will lead to cost pass-through.
- This approach recognises that large firms have significant fixed costs (unlike small firms in a 'perfect competition' market) that cannot be adjusted quickly to be responsive to prevailing market conditions.
- The trailing average is now used by overseas regulators (e.g., Ofgem in the UK³) and is proposed to be used by the Australian Energy Regulator (AER).⁴

³ Ofgem 2012, *Handbook for implementing the RIIO model*, p.108, 4 October. Available at: <https://www.ofgem.gov.uk/ofgem-publications/51871/riiohandbook.pdf> [Accessed 11 November 2013].

⁴ AER 2013, *Better Regulation: Explanatory Statement: Draft Rate of Return Guideline*, August.

- The trailing average approach will produce a less volatile Return on Debt allowance which will lead to less volatile prices for consumers, in accord with the NGO.
- This approach reflects efficient financing practices, in accord with the ARORO.
- The firm is not incentivised to match an inefficient benchmark.

Option F – Staggered maturities

- This approach is worse than Option A as not only does the firm need to refinance the entire debt portfolio every five years, there are additional intermediate refinancing points for smaller debt portions as well.
- The benefit of staggering maturities (recognised as being efficient) is negated by having maturities ultimately concentrated at one point in time.
- Again, the benchmark is not replicable for large debt holders.

2. Chairmont's scoring of the Trailing Average

Chairmont Consulting has assessed the trailing average approach with two “No” scores, which led it to reject the trailing average as a viable benchmark.⁵ WATC disagrees with these assessments.

1. Under the objective of “Promotion of economic efficiency”, the trailing average scores a “No” for “Use of prevailing market rates”.

All new refinancing and borrowing transactions for the benchmark firm are compensated at the prevailing cost of debt, rather than an historical average rate. That is, prevailing interest rates are regularly incorporated into the annually-updated trailing average, giving appropriate economic signals for new capital investment. This mechanism promotes economic efficiency, but does not penalise a firm that holds significant fixed debt costs that cannot be instantaneously changed.

2. Under the objective of “Provide reasonable opportunity to recover costs”, the trailing average scores a “No” for “Unbiased estimate of cost, and no certainty of cost recovery”.

For a firm holding a large debt portfolio, the trailing average is the *only* Return on Debt option that is replicable; indeed, all other options should score a “No” for the higher level objective criterion. The trailing average use prevailing (unbiased) market signals for new capital investment, and still provides the firm with a reasonable opportunity to recover its debt costs.

As noted above, the trailing average does not provide certainty of cost recovery as it is calculated using benchmark interest rates and applied to benchmark debt rather than the firm's actual debt balance. In practice, a firm will never exactly match the debt maturity profile of the trailing average portfolio, or exactly match the benchmark gearing, so there is little possibility that this mechanism will lead to cost pass-through.

⁵ Chairmont Consulting 2013, “Cost of Debt Comparative Analysis,” 5 November, p.24.

3. Revenue certainty

It emerged from the Workshop that revenue certainty is seen by the ERA to be a bad outcome for consumers as it is not observed in non-regulated firms. There are, however, some examples where non-regulated firms do have price certainty.

- Non-regulated monopoly businesses providing essential services will have stable revenues.
- Some public-private partnerships involving large capital investment in infrastructure have 'availability charges' when the investors do not want exposure to demand risk. This provides certainty in the revenue stream (subject to a service provider meeting performance criteria), but still promotes efficiency through benchmarking with a public sector comparator (the price of government delivery of the same infrastructure/services), i.e., the benefits for consumers are achieved by having an appropriate efficient benchmark. Examples can be found in the provision of water, schools, hospitals and prison services.

While it is not economically efficient to allow pass-through of inefficient costs it is not clear that the pass-through of an economically-efficient benchmark cost of funds is a problem. In fact quite the reverse – if you construct an economically-efficient benchmark and if this is the cost that is passed on to consumers, it is by definition efficient.

4. Concluding Remarks

The ARORO makes it clear that the Return on Debt allowance methodology should reflect the efficient financing and risk management practices that might be expected in the absence of regulation.

In its Explanatory Statement, the ERA states that:⁶

"Firms adopt a staggered debt portfolio as an efficient means to manage re-financing risk and the associated liquidity risk. Prudent management of re-financing risk lowers the cost of debt."

In addition, Chairmont explicitly state in the Executive Summary of their most recent report that:⁷

"Staggered debt issuance is both an efficient and sound risk management practice."

The trailing average approach to estimating the Return on Debt allowance clearly reflects efficient financing and risk management practice and is in accord with the ARORO.

Finally, the trailing average approach leads to more stable consumer prices, sends appropriate economic signals for new capital investment, and facilitates longer-term planning and budgeting by investors, in accord with the NGO.

⁶ ERA 2013, *Explanatory Statement for the Draft Rate of Return Guidelines*, Appendix 4, para. 14, p.240.

⁷ Chairmont Consulting 2013, "Cost of Debt Comparative Analysis," 5 November, p.3.