[redacted]

21 September 2020

Ms Nicola Cusworth
Chair, Economic Regulation Authority
Level 4, Albert Facey House
469 Wellington Street
PERTH WA 6000

Lodged online via www.erawa.com.au/consultation

Dear Ms Cusworth

**Re: Update of debt risk premium process**

Thank you for the opportunity to comment on the update to the debt risk premium process published on 7 September 2020. This letter outlines a submission from ATCO Australia (ATCO).

ATCO understand that the ERA are seeking to amend the debt risk premium process in response to Bloomberg removing access to the Swap Toolkit module and transferring the module into to a premium derivatives product from 1 October 2020. The ERA's notice states that maintaining the current process would result in an additional cost, of around US$50,000 per year, to access the premium product.

ATCO acknowledge that the amendments to the debt risk premium process published on 7 September 2020 are a pragmatic response to avoid this additional cost burden, which will ultimately be borne by ATCO and the other network service providers in the short term and consumers in the longer term.

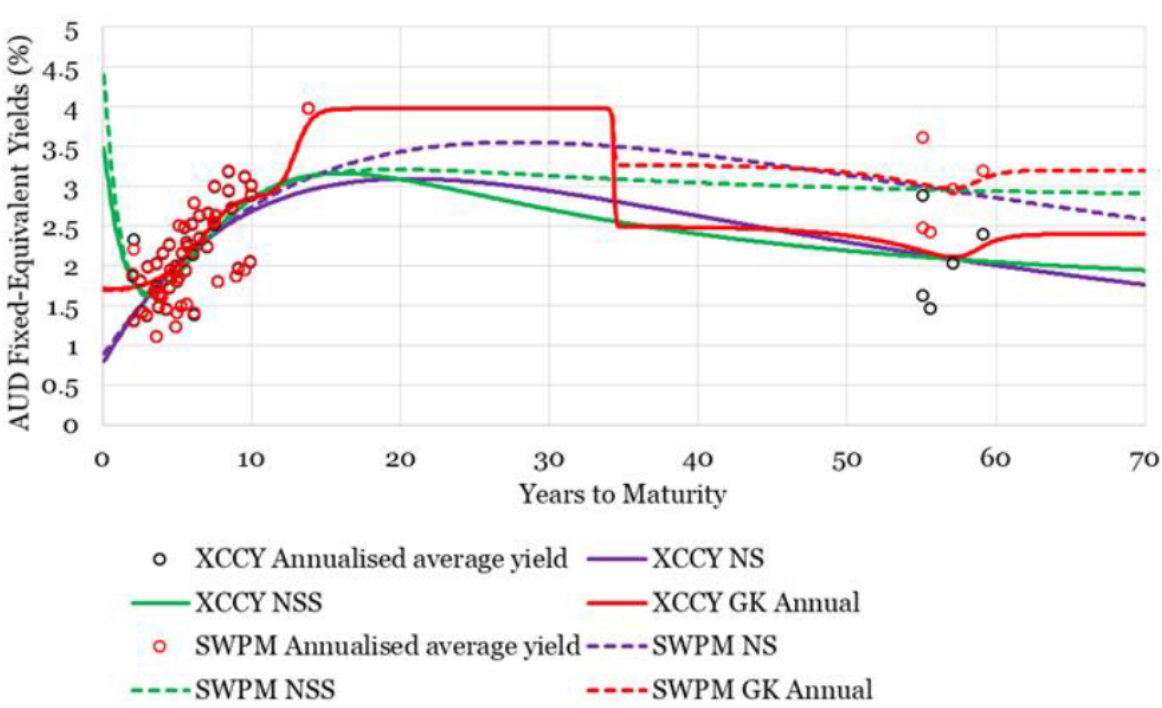
ATCO's November 2018 submission to the ERA on the debt risk premium estimation process flagged that the transparency of the debt risk premium process is hindered by the use of proprietary Bloomberg data and that validation of the debt risk premium outcome would require access to the Bloomberg Anywhere subscription. Instead ATCO proposed that the ERA consider the adoption of published debt yield curves as a more transparent and replicable estimate of the debt risk premium. The change in access to the Swap Toolkit module demonstrates that this simpler method has additional benefits as it could have avoided this situation.

Given the complexity of the current debt risk premium process, as well as the short consultation period on this matter, ATCO commissioned CEG to investigate the impact of the proposed change to the annual debt risk premium (DRP) update process. A memorandum from CEG summarising their analysis is attached to this submission.

Analysing data from 2016 to September 2020 CEG found, with the exception of 2018 and 2019, lower DRP values produced under the new method compared to the old method as shown in the table below.

| | XCCY (new method) | | | | SWPM (current method) | | | | Variance |
|---|---|---|---|---|---|---|---|---|---|
| | NS (%) | NSS (%) | GK (%) | CoD (%) | NS (%) | NSS (%) | GK (%) | CoD (%) | CoD (bps) |
| **2016** | 4.56 | 4.54 | 4.53 | 4.54 | 4.59 | 4.58 | 4.52 | 4.56 | -2 |
| **2017** | 4.72 | 4.81 | 4.77 | 4.77 | 4.73 | 4.82 | 4.78 | 4.78 | -1 |
| **2018** | 4.70 | 4.72 | 4.78 | 4.73 | 4.69 | 4.70 | 4.77 | 4.72 | 1 |
| **2019[1]** | - | - | - | 3.00 | - | - | - | 2.99 | 1 |
| **2020[2]** | 2.69 | 2.84 | 3.05 | 2.86 | 2.74 | 2.84 | 3.06 | 2.88 | -2 |

CEG also found that the differences between the new and old method is more pronounced the longer the time to maturity of the bond over 10 years as shown on the figure below for 2020.




The ERA should further investigate the influence of bonds with a maturity date greater than 30 years, and any potential bias introduced by the new method, due to CEG findings that these bonds have a larger variance between the two methods.

In April 2019, the WA Government implemented legislation that made the ERA's rate of return guidelines a mandatory binding instrument having the force of law. In considering whether to approve this change to the debt risk premium process the Authority should carefully consider:

- that Section 30C of Division 1A (Rate of Return Instrument) of the National Gas Law[3] binds the ERA and network service providers to the debt risk premium process that was published on 18 December 2018
- that Section 30E(2)(b) of the National Gas Law requires that the debt risk premium process is actually part of the binding instrument, and must provide for the methodology to apply automatically without the exercise of any discretion by the ERA

[1] The cost of debt estimates shown for 2019 are ERA estimates
[2] CEG bond sample using 20 trading days to 18 September 2020
[3] Applying as a law of Western Australia pursuant to the *National Gas Access (WA) Act 2009*

- that Division 1A of the National Gas Law does not include provisions that contemplate or permit *amendment* of the binding instrument during the period that it is force or the amendment of components of the binding instrument, for example by way of amending an appendix to the Explanatory Statement as described in the ERA's 7 September 2020 notice
- that as Section 30O and Section 30P of the National Gas Law specify the process of *review and replacement* of the binding instrument, is the ERA permitted to make this amendment at this time or is the ERA's ability limited to next reviewing and replacing the debt risk premium process as part of the review and amendment of the binding instrument on 18 December 2022[4]

Subject to the ERA satisfying itself that it is permitted under the provisions of the National Gas Law to make the changes to the debt risk premium process at this time, then on balance ATCO supports the proposed changes.

If you have any questions or would like to discuss any of these issues further please contact me or John Ivulich, Chief Financial Officer.

Yours sincerely

[redacted]

**J.D. Patrick Creaghan**
Managing Director & Chief Operating Officer

Attachment 1: CEG Memorandum

[4] COAG Energy Council's position on the final legislation was that it does not include a re-opener. The overall policy intent of the binding instrument is to provide regulatory stability and certainty. They stated that allowing the potential for it to be reopened could be counterproductive, the instrument will be in force for 4 years and the inclusion of a re-opener within this short window is likely to create unnecessary regulatory uncertainty. (Source: http://www.coagenergycouncil.gov.au/sites/prod.energycouncil/files/publications/documents/Binding%20Rate%20of%20Return%20-%20SCO%20Bulletin%20-%2027%20June%202018.pdf)

# CEG MEMORANDUM

## ATTACHMENT 1

EIM# 103146831

PUBLIC
21 September 2020

[redacted]

# Memorandum

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|---|---|
| To: | [redacted] ATCO |
| From: | [redacted] CEG – Asia Pacific |
| Date: | 21 September 2020 |
| Subject: | **Review of change in ERA's DRP methodology** |

## 1 Introduction

1. The ERA's current method for estimating ATCO's debt risk premium (DRP) uses Bloomberg's swaps toolkit to generate AUD fixed equivalent yields from a bond sample that includes bonds denominated in AUD and foreign currency, as well as fixed and floating coupons.

2. As Bloomberg intends to shift its swaps toolkit functionality to a premium product that costs extra USD 50,000 per annum, the ERA proposes to modify its method for estimating ATCO's debt risk premium using an alternative method in which Bloomberg's "YAS XCCY" (cross-currency yield and spread analysis) function is used to bypass the swaps toolkit. This memorandum assesses the impact of such a shift on ATCO's benchmark DRP estimate.

## 2 Updating previous estimates using ERA's proposed methodology

3. We have applied the ERA's proposed methodology to the bond samples used to generate ATCO's DRP estimates from 2016-2020.[1] We then ran the ERA's R code, using the bond yields from each sample as inputs. The resulting cost of debt estimates are shown in Table 2-1 for the current SWPM approach and the proposed YAS XCCY approach.

[1] ATCO provided us with the bond sample determined by the ERA in October 2019. We identified a new bond sample for 2020 using Bloomberg's SRCH function based on the ERA's search criteria.

The bond samples from 2016-2018 were obtained from work that we had previously conducted for ATCO in those years.

## Table 2-1: Comparison of benchmark annualised cost of debt estimates using current and proposed methods and ERA's R code

| | YAS XCCY (proposed method) | | | | SWPM (current method) | | | | Diff^ |
|---|---|---|---|---|---|---|---|---|---|
| | NS | NSS | GK | CoD | NS | NSS | GK | CoD | CoD |
| 2016 | 4.56 | 4.54 | 4.53 | 4.54 | 4.59 | 4.58 | 4.52 | 4.56 | -0.02 |
| 2017 | 4.72 | 4.81 | 4.77 | 4.77 | 4.73 | 4.82 | 4.78 | 4.78 | -0.01 |
| 2018 | 4.70 | 4.72 | 4.78 | 4.73 | 4.69 | 4.70 | 4.77 | 4.72 | 0.01 |
| 2019* | - | - | - | 3.00 | - | - | - | 2.99 | 0.01 |
| 2020# | 2.69 | 2.84 | 3.05 | 2.86 | 2.74 | 2.84 | 3.06 | 2.88 | -0.02 |
| 2020 (remove long dated)## | 2.84 | 2.82 | 3.05 | 2.90 | | | | | |

*Source: Bloomberg, ERA, CEG analysis; ^Defined as proposed YAS XCCY estimate minus current SWPM estimate; *The cost of debt estimates shown for 2019 are ERA estimates; #Our estimates for 2020 use an averaging period of 20 trading days from 19 August 2020 to 15 September 2020.## These are results if bonds with large SWPM vs XCCY variances are removed (all have maturity >50 years) – see discussion below.*

4. We observe from the last column of Table 2-1 that the cost of debt estimates generated using the proposed YAS XCCY method are similar but typically lower than the corresponding estimates from the current SWPM method.[2] Over the five years from 2016 to 2020, the proposed method results in a lower cost of debt in three of the five years, with 2018 and 2019 as the exception.

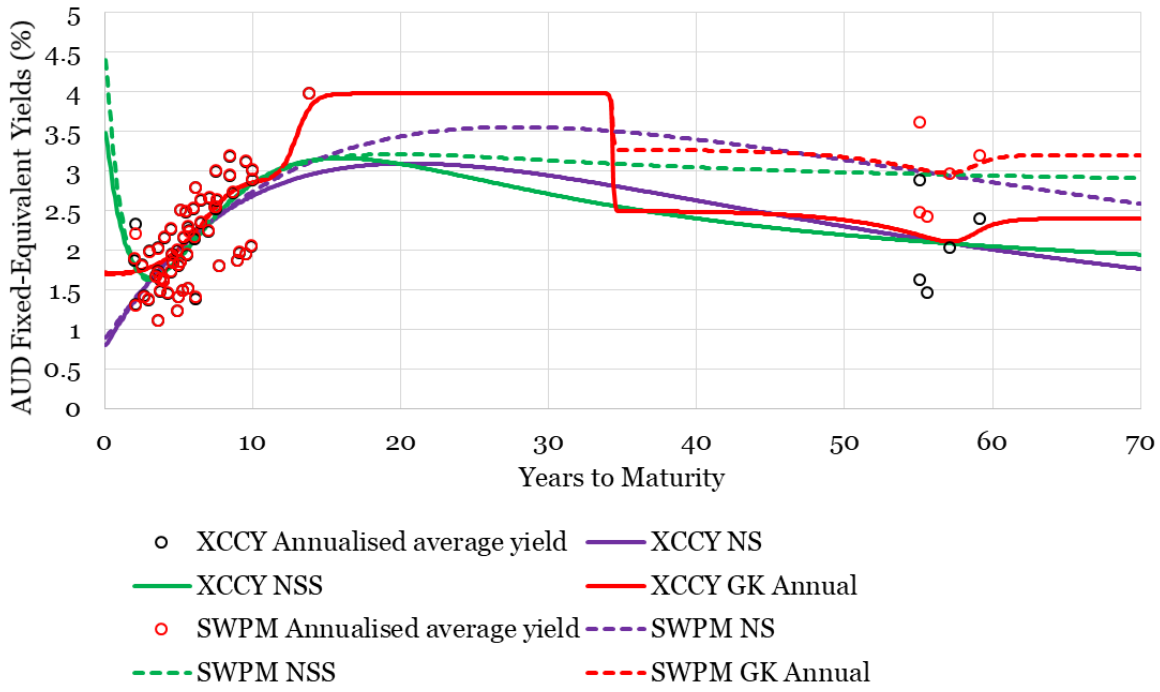
5. Figure 2-1 shows the bond yields and fitted curves for the 2020 sample. It can be seen that the individual bond yields generated using the current SWPM method and the proposed YAS XCCY method are fairly similar except for the five long-maturity bonds, where the yields obtained from the newly proposed method are materially lower. These systematic differences are likely to explain the systematic differences in Table 2-1. On this basis, it is reasonable to estimate the XCCY method, relative to the SWPM method, will typically depress future cost of debt estimates to a similar degree as it has in the past 5 years.

6. The last row of Table 2-1 shows the 2020 cost of debt under the proposed method with the long-maturity bonds removed as a sensitivity analysis – given that it appears to be these bonds that drive the difference between SWPM and XCCY estimates. The modified sample generates a cost of debt (2.90%) that is higher than that of the original sample under the current SWPM method (2.88%) and the proposed YAS XCCY method (2.86%) by 2 bp and 4 bp respectively.

[2] The differences can be attributed to two sources. First, Bloomberg's swaps toolkit calculates the AUD fixed equivalent yields differently from the YAS XCCY function.

Second, our analysis suggests there are a small number of bonds for which AUD fixed equivalent yields can be obtained using one method but not the other. This means that the samples used to fit the curves under each approach may be slightly different.

**Figure 2-1: Bond yields and fitted curves for 2020**




*Source: Bloomberg, ERA, CEG analysis*