APA Group

Goldfields Gas Pipeline Access Arrangement 2009

Ongoing Debt and Equity Raising Costs
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Introduction

This paper addresses ongoing debt and equity raising costs, which are separate to the upfront costs incurred in raising debt and equity funding. The most common assumption applied for recovery of debt issuance costs in regulatory decisions has been inclusion of a 12.5 basis point adjustment to the cost of debt. Ongoing equity raising costs are normally only considered where there is a large capital expansion and the equity portion of the funding is greater than could be funded from retained earnings.

This paper examines the quantum and treatment of ongoing debt and equity raising costs.

Equity raising costs

Over time, the operations of a business will grow. When major capital expenditure is required and new equity must be raised, additional equity raising costs will be incurred. Major capital expenditure will incur additional equity raising costs as retained earnings are insufficient to fund such expenditure. Adjusting the Capital Base for the additional equity raising costs transparently overcomes this problem.

It is understood that the GGP is not planning any major capital expansion of the covered pipeline in the next Access Arrangement period. We have therefore not examined these costs in any more detail at this time.

Debt raising costs

It is common practice to include a separate allowance for ongoing debt raising costs, either as an increment to the debt margin or as an allowance in the cash flows. Unlike the debt margin, these ongoing costs are less specific to the business, although may vary depending on the volume of debt raised and the manner in which it is raised, noting that there are some economies of scale in raising and managing debt. Referencing previous regulatory decisions (which have sourced estimates of these costs from financial institutions) is therefore considered appropriate starting point. Allowances approved in recent regulatory decisions are included in the following table.

Table 1 Debt margin: recent regulatory decisions

Regulator (year)	Industry	Allowance
ACCC (2008)	Rail	12.5 basis points
ERA (2008)	Rail	12.5 basis points
QCA (2006)	Electricity distribution	12.5 basis points
ESCOA (2005)	Electricity distribution	12.5 basis points
ICRC (2004)	Water	12.5 basis points
IPART (2005)	Gas	12.5 basis points
QCA (2005)	Rail and electricity distribution	12.5 basis points
ESC (2005 - draft)	Electricity distribution	12.5 basis points
IPART (2005)	Rail	12.5 basis points
IPART (2004)	Electricity distribution	12.5 basis points
QCA (2004)	Ports	12.5 basis points
ICRC (2004)	Rail and electricity distribution	12.5 basis points

An assumption of 12.5 basis points is now consistently applied in regulatory decisions.[1] The cost covers underwriting fees, legal and road-show costs, the fixed costs of obtaining an issuer credit rating, registry fees and paying agent fees. In our view, the established precedent of 12.5 basis points remains reasonable in stable debt markets.

Impact of the global financial crisis

The global financial crisis has made debt more difficult to place, particularly for lower rated businesses. It is therefore possible that this has had a significant impact on debt and equity raising costs, particularly underwriting fees. This in turn highlights the trade-off between direct and indirect costs – in these difficult financial market conditions, either the 'discount' offered to debt and equity holders will need to increase in order to source new capital (this is an indirect cost that is not reflected in the estimates provided above) or the fees paid to underwriters will need to increase. It is also possible that both could have increased.

[1] The most notable exception was the 2002 decision with respect to GasNet, where the Australian Competition Tribunal overturned a decision by the ACCC and allowed a margin of 25 basis points, which was submitted by GasNet.

We understand from discussions with APA that current actual debt raising costs are above 12.5 basis points. This anecdotal evidence is consistent with the view put forward above that the global financial crisis will increase the cost of raising debt. To date we are unaware of any studies or independent quantitative analysis which quantifies the potential impact on the average firm, but the position that debt raising costs have increased seems reasonable.

As such the regulatory benchmark of 12.5 basis points may be at the low end of a reasonable range at the current time.

Conclusion

The costs of raising debt and equity funding to develop and expand major infrastructure is a legitimate cost that needs to be compensated. Compensation for both initial and ongoing debt and equity raising costs need to be provided. In relation to ongoing costs, we recommend that:

- equity raising costs for subsequent major capital expansions should be added to the Capital Base in proportion to the benchmark equity funding level, based on the allowance proposed for initial equity raising costs (currently estimated at 5.1% to 5.7%); and
- debt issuance costs of at least 12.5 basis points should either be added to the debt margin or included as an allowance in the cash flows (the former treatment is assumed). The previously accepted benchmark of 12.5 basis points is likely to currently be below the costs actually being incurred by businesses given the difficulties in raising debt due to the global financial crisis.

These estimates are considered conservative as they do not consider indirect costs, nor do they reflect any increase in the costs of raising both debt and equity which may have occurred following the global financial crisis.