WestNetRail

7 January 2011

Dr Duc Vo
Senior Analyst
Economic Regulation Authority
PO Box 8469
Perth BC WA 6849

By email: publicsubmissions@Authoritywa.com.au

Dear Dr Vo

Measuring the Debt Risk Premium: A Bond-yield Approach

Background

WestNet Rail (WNR) welcomes this opportunity to comment on the Discussion Paper: *Measuring the Debt Risk Premium: A Bond-yield Approach.*

The debt risk premium is one component of the weighted average cost of capital (WACC). It is added to the nominal risk free rate and debt issuance costs to form the nominal pre-tax return on debt part of the WACC.

When estimating the debt risk premium the Economic Regulation Authority (Authority) has consistently, since 2003 assumed a borrowing term of 10 years. To do this the Authority has in past decisions relied on the estimates of 10-year fair yield curves derived by Bloomberg and CBASpectrum.

As detailed in the discussion paper WNR recognises that from September 2010 CBASpectrum has ceased publishing its estimates and Bloomberg has progressively shortened the duration of its fair yield curves. Furthermore, from 22 June 2010 Bloomberg ceased publishing a 10-year fair yield curve across all credit ratings therefore making it impossible for the Authority to perform its current extrapolation calculation. The Authority would have to devise its own extrapolation method in order to continue to use a term of 10 years, which would further increase the instability of the estimate.

The current Australian bond market is significantly different than in the past. It is very illiquid for long term bonds with terms to maturity of 5 years and above. This is a direct outcome of the global financial crisis (GFC) and it is expected that the longer end of the market will return over

time. Firms however in the absence of available longer term debt, today rely on shorter term debt than in the past and CBASpectrum's and Bloomberg's actions are a reflection of this trend.

WNR also notes that CBASpectrum estimates were chosen to calculate the debt risk premium in the Authority's August 2010 Draft Decision on WA Gas Networks' (WAGAS) proposed access arrangement. The draft document stated it could not use Bloomberg estimates because of the absence of a 10-year fair yield and would investigate alternative approaches for inclusion in its final decision.

In light of this WNR recognises that a different approach to estimating the debt risk premium has to be developed.

Approach

Given the restrictions placed on the Authority WNR, is in principal, generally supportive of the Authority's proposed move to a bond-yield approach, which mainly relies on a sample of bond yields observed directly from the Australian market but only as an interim measure until the longer dated debt markets return to normal. WNR continue to support the existing practice of using the 10 year fair yield curves as the preferred approach.

There are, however a number of complex issues that need to be resolved before such an interim approach is adopted, specifically:-
WNR believes the Authority should not completely exclude Bloomberg's yield curves from the calculation. Completely abandoning estimates published by Bloomberg represents a fundamental shift from previous practice. Bloomberg is a recognised source of information, trusted by the financial markets and the Authority for many years, despite its lack of transparency. There is insufficient evidence to abandon Bloomberg's estimates completely from the debt risk premium calculation as we believe that this market will return to normal over time

As shown in Figure 2 of the Discussion Paper the thinness of the bond market has meant that Bloomberg's estimate of the 7-year BBB fair yield curve is substantially different from the observed bond yields in the Australian bond market but this is as much a function of the thin bond market as much as Bloomberg's calculation.

Given Bloomberg's progressive shortening of available yield curve durations, WNR accept that extrapolation to a 10-year term is at best unstable and at worst impossible to calculate (since there are no 10-year curves available to base the extrapolation on) therefore this is little choice but to use a shorter duration.

However, Bloomberg's 5 and 7-year fair yield curves are still longer than the average time to maturity of the Australian corporate bonds included in the sample. Including either of Bloomberg's 5 or 7-year yield curves in the sample helps maintain a consistent approach with

the existing methodology and provides sustainability of the calculation into the future. It is quite possible that in the future the sample of Australian corporate bonds may be significantly thinner than at present leaving the calculation to be based on just one or two bonds.

There are factors other than credit rating that influence bond prices such as the specific relevant industry, the underlying assets (e.g. potential M&A activity), reputation of the company and covenants of the bond. Furthermore, at times the credit rating may not be an accurate reflection of default risk due to information asymmetry between the company and the market. The thinness of the market could mean the calculation becomes biased towards these other factors.

WNR supports the Authority's method for determining the sample of Australian corporate bonds but acknowledges there are issues in establishing a credible sample.
Since the onset of the GFC, a company's industry sector appears more important that its credit rating in determining its debt margin. However, as the Discussion Paper points out, satisfying the "same industry" criterion significantly reduces the sample size to just a handful. Broadening the selection to include all bonds with a credit rating in the "BBB band" is sensible and is consistent with the principal that the debt risk margin is expected to reflect the credit rating and the maturity of a security. However, this means bond yields from corporations outside the regulated utility sector are used to determine the debt risk premium for WNR.

WNR prefers the "number of years until maturity" weighting approach to observed yields as this places more weight to the bonds with longer durations to maturity.

However WNR proposes that the calculation of the debt risk premium should be made with reference to a nominal risk-free rate duration comparable to the weighted term to maturity of bond yields used in the sample rather than the 10-year risk free rate.
The calculated debt risk premium can then be added to the 10-year risk free rate (which remains publicly available on a daily basis i.e. Reserve Bank of Australia (RBA)) and issuance costs to form the nominal pre-tax return on the debt part of the WACC.

Summary

To summarise, WNR is, in principal, supportive of the Authority's bond yield approach to determine the debt risk premium but only as an interim measure.

However, there a number of complex issues that cannot be resolved in such a short timeframe. In the interests of regulatory certainty and to finalise the WAGAS decision we submit that the calculation of the debt risk premium remains as a consistent as possible with previous practice and further consultation time is given to the development of a new approach that includes Australian corporate bonds.

To this end Bloomberg's longest available fair yield curve estimate alone should be used to calculate the debt risk premium until further analysis and consultation has been made. To the extent a shorter duration to maturity has to be used then a comparable risk free rate term should be used to calculate the premium before it's used to calculate the total cost of debt in the WACC.

Yours faithfully

Allan Rose
Commercial Manager
WestNet Rail
(08) 9212 2602
arose@wnr.com.au