AUSTRALIAN RAIL TRACK CORPORATION LTD

Ref No:

7 January 2011

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

Dear Dr Vo

MEASURING THE DEBT RISK PREMIUM: A BOND YIELD APPROACH

ARTC SUBMISSION

ARTC welcomes the opportunity to respond to the Economic Regulation Authority's (the ERA's) Discussion Paper entitled "Measuring the Debt Risk Premium: a Bond-Yield Approach". ARTC acknowledges the difficulties faced by the ERA and all regulators in estimating a debt margin for regulated businesses, noting that this margin must be "commensurate with the prevailing conditions in the market for funds". [1]

All Australian regulators are currently confronted with the challenging task of estimating a long-term forward-looking debt margin with only very limited market data available. It remains unknown as to when liquidity will return to the Australian corporate bond market, particularly for BBB firms.

In November 2010 the Independent Pricing and Regulatory Tribunal (IPART) also released a Discussion Paper proposing changes to the methodology that it has used to estimate the debt margin.[2] Its current approach is to reference Bloomberg's seven year fair value yield and three bonds rated

[1] Economic Regulation Authority (2010), Discussion Paper, Measuring the Debt Risk Premium: A Bond Yield Approach, 1 December, para.2.

[2] Independent Pricing and Regulatory Tribunal (2010), Developing the Approach to Estimating the Debt Margin - Other Industries - Discussion Paper, November.

BBB+ and A- by Standard and Poor's. (ARTC notes that as at 31 December 2010, two of these bonds were referenced by Bloomberg in the sample it uses to construct its fair value curve. This will result in double counting.)

IPART is reviewing the 'quality' of the securities referenced in its sample and the methodology used to estimate the debt margin. This includes referencing other sources of data, including bonds issued in the US market.

ARTC lodged a detailed submission in response to IPART's review. While it is not relevant to examine the specifics of that review in detail here, the drivers of both reviews are the same, being the ongoing lack of liquidity in the corporate bond market. With the number of BBB/BBB+ bond issues remaining limited, both the ERA and IPART are considering expanding the sample of bonds that are used to estimate the debt margin.

ARTC's IPART submission is available on the IPART website.

ARTC agrees that the limited number of BBB/BBB+ bond issues is a problem. This problem is made worse by the fact that most of these bond issues are for maturities materially shorter than ten years. In reality, BBB rated businesses are having to look at a number of alternatives to raise debt funding (as has always been the case), including bank debt. The regulator's task is to determine the best estimate of the forward-looking cost of debt for the 'efficient benchmark firm', recognising that the actual funding options available to each regulated business will vary. Some businesses will also be faced with more limited choices than others.

ARTC also agrees that in theory, a larger sample of bonds would be desirable. However, this should not be at the expense of the integrity and quality of that sample. The quality of the estimate will not be improved if the data included in that sample is not of sufficient quality to meaningfully inform an estimate of the forward-looking cost of debt for the 'efficient benchmark' BBB rated firm. Instead, the inclusion of such data will compromise the estimate and will not result in a debt margin that is "commensurate with the prevailing conditions in the market for funds".

Historically, most Australian regulators have relied on Bloomberg's fair value estimates to estimate the debt margin. The ERA is now proposing to discontinue reliance on these estimates and construct its own sample of bond yields of varying terms to maturity – the same sample of bonds that is also available to Bloomberg to develop its fair value yield curves. Bloomberg

AUSTRALIAN RAIL TRACK CORPORATION LTD ABN: 75 081 455 754
Off Sir Donald Bradman Dr, Passenger Rail Terminal Rd, Mile End SA 5031, P.O. Box 10343, Gouger Street, Adelaide SA 5000
Te: (08) 8217 4366 Fax: (08) 8217 4578

is a respected organisation that specialises in the provision of financial market data. If it has not referenced particular bonds in the sample it uses to derive its yield curves, ARTC considers that the ERA should be asking why.

As will be noted further below, the possible answer is that the bonds that are not referenced are not being actively traded and/or are considered outliers by Bloomberg. If this is the case, the yields on these bonds are not providing information regarding the cost of debt that is "commensurate with the prevailing conditions in the market for funds". A short response to each of the ERA's five questions is provided below.

1. Is the Authority's proposed approach of estimating the debt risk premium likely to better reflect the prevailing conditions in the market for funds than the use of current Bloomberg's estimates of fair value yield curves?

ARTC does not agree that the ERA's proposed approach will produce a better estimate of the debt margin than Bloomberg's fair value yields. Instead, ARTC considers that the ERA's proposed approach could result in an inferior outcome because it may be referencing market data that is not sufficiently reliable.

In response to IPART's debt margin review, ARTC submitted a report prepared by Synergies Economic Consulting.[3] One of the issues considered in that report was why Bloomberg may not be including certain BBB bonds in the sample it uses to develop its fair value curves. It was noted that in order for a bond to be included in Bloomberg's sample, it needed to be considered 'well priced'. It only includes bonds that have a 'Bloomberg Generic' price, which is:

... the simple average price of all kinds of prices, including indicative prices and executable prices, quoted by our price contributors over a specified time window... [4]

It considers that the availability of such a price "is an indication of good liquidity for that bond".[5] Outliers are also excluded.

[3] Synergies Economic Consulting (2010), Developing the Approach to Estimating the Debt Margin, Submission in Response to IPART Discussion Paper.
[4] M. Lee (2007), Bloomberg Fair Value Market Curves, International Bond Market Conference, Taipei.
[5] M. Lee (2007).

The Synergies report examined why liquidity is so important for the purpose of estimating the debt margin for regulatory purposes. It stated that a key function of a market is price discovery. This in turn depends on the frequency of trading. If there is little or no trading, prices will not reflect current information. If prices do not reflect current information, they cannot result in an estimate that is "commensurate with the prevailing conditions in the market for funds". Synergies noted that there is a volume of literature that addresses the nature of the problem and its potential impact on the reliability of prices.

The ERA has not made any reference to this issue in its Discussion Paper, nor has it considered why certain bonds that it proposes to include in its broadened sample are not referenced in Bloomberg's sample. Bloomberg is a respected provider of financial market information. It is considered reasonable to question why bonds that the ERA proposes to reference are not referenced by Bloomberg.

Regulators including the ERA have historically relied on Bloomberg's fair value estimates. Most Australian regulators solely relied on it prior to the global financial crisis. Following the commencement of the crisis, more regard was subsequently given to the estimates produced by CBA Spectrum, which are no longer published.

The ERA has provided no compelling reason as to why the same reliance can no longer be placed on Bloomberg's fair value estimates. It only makes reference to the observed difference between the seven year fair value yield and observed yields on BBB/BBB+ bonds, a number of which are not currently included in Bloomberg's sample that is used to develop its fair value curve (as at 31 December 2010) and hence could be illiquid. It also notes that it is not able to reconcile the difference because the methodology Bloomberg uses to develop its curves is not known. ARTC does not agree that this supports a departure from Bloomberg. On the contrary, the ERA's proposed approach risks imposing an inferior outcome.

Accordingly, recognising the problems facing all market participants given the lack of liquidity in the corporate bond market, ARTC is of the view that reliance should continue to be placed on the fair value yield curves produced by an independent organisation that specialises in the production of financial market data. Even though the data that is available on individual bond issues is limited, in order to produce the best possible estimate under the circumstances, regard must be given to the potential quality of each of the

AUSTRALIAN RAIL TRACK CORPORATION LTD ABN: 75 081 455 754
Off Sir Donald Bradman Dr, Passenger Rail Terminal Rd, Mile End SA 5031, P.O. Box 10343, Gouger Street, Adelaide SA 5000
Te: (08) 8217 4366 Fax: (08) 8217 4578

yields that is referenced in developing the estimate. Relying on data that may not be reliable could result in regulatory error.

At the current time, this means continuing to rely on Bloomberg's fair value curves and not replacing it with an extended sample that includes yields on other bonds that are not referenced in the development of Bloomberg's yield curves.

2. Is the use of a benchmark sample of Australian corporate bonds with a term shorter than 10 years likely to better reflect the prevailing conditions in the market for funds than the use of Bloomberg's estimates of fair yield curves to derive a ten year term?

The intent of this question is not clear. Bloomberg derives its yield curve from its sample of BBB bonds. This sample includes bonds of varying terms across the maturity spectrum (recognising that given the lack of liquidity in the market, the bonds are currently concentrated in the shorter maturities). Bloomberg then builds a yield curve, or 'fits a line' to all of these yields. This is a single curve plotting BBB yields out to a maturity of (currently) seven years. All of the bonds in the sample inform the development of that curve.

The ERA's proposal to include bonds with at least two years to maturity will therefore not necessarily add any additional information to what Bloomberg currently uses in constructing its yield curves. However, what is different is that Bloomberg has regard to liquidity in its selection process and considers whether an estimate might be an outlier.

3. Is the Authority's approach to the selection of Australian corporate bonds appropriate?

ARTC agrees that bonds should have the same Standard & Poor's credit rating as the regulated business. ARTC also concurs that requiring the bonds to be issued by firms in the regulated utility sector will be too limiting.

ARTC also agrees that the market should be limited to the Australian domestic market, as bond prices in other jurisdictions could be driven by different factors. Not all businesses are able to access overseas markets and then only to varying degrees. Estimating a cost of debt that reflects the costs of raising funds in these other markets could result in that estimate that is not representative of the cost of raising funds for a regulated business in Australia.

ARTC

ARTC's main concern with the ERA's approach is its proposal to include bonds in the sample whose yields could be influenced by different factors. One of these factors, as outlined above, is a lack of liquidity. It also has concerns with incorporating bullet and callable/puttable bonds, unless some adjustment is made for the impact that these different features can have on the yield on the bond.

4. Which method for calculating the weighted average of observed yields from the sample should be used?

ARTC does not agree that it is appropriate to use any form of averaging of yields on bonds with different maturities. The most appropriate approach to apply is to derive a yield curve from the data and then interpret the yield on the relevant maturity from this yield curve. This is the approach that Bloomberg applies. It builds a fair value curve based on the data for the bonds in its sample.

These processes are typically complex. Even if the methodology used by Bloomberg to construct its curves was known, it would be very difficult for stakeholders to replicate without access to the same specialist expertise. However, given Bloomberg specialises in this area, there is no reason to consider that the methodology it uses would not be appropriate. More importantly, averaging data that should not be averaged (being yields on bonds with different maturities) could result in a worse outcome.

5. Are there any sources of information that the Authority has not considered in this discussion paper with regard to estimating the debt risk premium?

As outlined above, ARTC agrees that in theory, it is desirable to increase the size of the sample if possible. However, there is only benefit in doing this if the additional information included is independent and reliable. It also needs to be relevant to the estimation of the cost of ten year debt for a business based on its assumed credit rating. For example, businesses will also access the bank debt market to raise funds. However, the cost of this funding is usually specific to the risks and circumstances of the business. More important, this information is not readily available and even if information could be sought, the quoted margins are not necessarily transparent (so it may not be valid to make comparisons between them).

AUSTRALIAN RAIL TRACK CORPORATION LTD ABN: 75 081 455 754
Off Sir Donald Bradman Dr, Passenger Rail Terminal Rd, Mile End SA 5031, P.O. Box 10343, Gouger Street, Adelaide SA 5000
Te: (08) 8217 4366 Fax: (08) 8217 4578

For reasons such as this, regulators have tended to rely on corporate bond information because the data is accessible, independent, relevant and comparable. The emergence of the global financial crisis has meant that this information is more limited. Information is limited across the board (that is, not just in the corporate bond market). As outlined above, there is a potentially significant trade-off between the benefit of having more information and the costs of using information that does not reasonably inform an estimate of the benchmark cost of debt that is "commensurate with the prevailing conditions in the market for funds". Any alternative sources of data therefore must continue to be viewed with considerable scrutiny.

The submission contains no information that ARTC would consider commercial-in-confidence.

For further information regarding the preparation of this submission, please contact Mr. Glenn Edwards, (08)82174292, gedwards@artc.com.au

pp

Simon Ormsby
General Manager Commercial