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Letter to Warwick Anderson, Response to AER criticisms of estimates of average term of debt at issue, Tom Hird, Competition Economists Group (CEG) November 2013

Appendix 9.7

27 November 2014

Response to the ERA's Draft Decision on required amendments to the Access Arrangement for the Mid-West and South-West Gas Distribution System

Connecting WA
to natural gas

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11 November 2013

Dear Mr Anderson

Response to AER criticisms of estimates of average term of debt at issue

This letter is in response to the Australian Energy Regulator's (AER's) critique of CEG's debt term analysis in our June 2013 report[1]:

> *"The CEG analysis used Bloomberg data only for estimating the term at issuance which does not represent the full data on debt portfolios.[2] In particular, the Bloomberg dataset does not include comprehensive data on bank debt. We understand that bank debt accounts for around one third of the businesses portfolio. Given that bank debt tends to be a much shorter term at issuance, the lack of bank debt data in CEG's sample means that the term at issuance for the total debt portfolio is likely to be shorter than the estimates presented by CEG."*[3]

The explanatory statement does not provide a source for the claim that bank debt accounts for around one third of the businesses' debt portfolios. Having examined the actual debt portfolios of private Australian energy network businesses regulated by the AER,[4] I can confirm that drawn bank debt, on average, comprises only 11% of these businesses' debt portfolio, which is significantly less than the amount claimed by the AER.

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[1] CEG, *Debt strategies of utility businesses*, June 2013.

[2] CEG, *Debt strategies of utility businesses*, June 2013, footnote 3, p. 8.

[3] AER, *Better Regulation, Explanatory statement, Draft rate of return guideline*, August 2013, p. 155.

[4] Cheung Kong group (SA Power Networks, CitiPower and Powercor), Envestra, Electranet, SP AusNet, DUET group (Multinet Gas and United Energy), and APA group. A confidential spreadsheet that will be forwarded to the AER at the same time as this letter contains the details of these portfolios. The only additional information I have relied on is the $81m value of cash and cash equivalents reported in APA's 2013 annual report.

In addition to this use of drawn bank debt, firms also use undrawn bank debt to provide the liquidity reserves[5] for credit rating and operational purposes and working capital necessary to run a business (smooth cash flows and receipts and ensure funding is available to repay debt as it falls due). Available bank debt comprises 22% on average, of the comparable businesses total available (drawn plus undrawn) debt portfolio. However, most of this is undrawn bank debt which represents 14% of total drawn debt – which is higher than the 8% estimate figure used by PwC to estimate the costs of liquidity management.[6]

This data suggests that CEG overestimated the proportion of available bank debt (24%) in our previous report. Consistent with this, the data of individual company's average term of issuance is, actually, higher than estimated in our report.

The sample of businesses originally examined by us was as set out in footnote 4 but did not include (the non-listed) ElectraNet. For this sample, the simple[7]/weighted average of term to maturity at issue for all drawn debt is 11.3/10.6 years. However, we have also been provided debt portfolio information for ElectraNet which is another privately owned energy network business regulated by the AER (albeit not listed). Including ElectraNet in the sample reduces the simple/weighted average of term to maturity at issue of all drawn debt to 10.9/10.5 years.

These estimates treat all debt in the same way. Specifically, one dollar of short term drawn bank debt is treated equivalently (given the same weight) as $1 of debt raised by bond issuance. In our view this artificially depresses the measure of term below that which we are interested in. Specifically, we are interested in debt used to fund the regulatory asset base (RAB) – which is the debt that is compensated through the cost of debt allowance. However, liquid short term debt is used to fund liquid financial assets in addition to, or instead of, the long term fixed assets in the RAB.

In order to account for this use of bank debt each business has provided the value of cash and cash equivalents or other liquid funds put aside for the purpose of repayment of near term debt maturity. That is, short term cash assets and short term bank debt are essentially the same thing with the opposite sign (if you borrow a dollar from a liquid bank facility and hold it as a dollar in liquid cash your net debt has not increased nor has the term of your net debt altered). We have treated such liquid financial assets as 'negative bank' debt with the same term as the shortest term bank debt on each company's books (the effect of which is to 'cancel out' that bank debt – consistent with the fact that rather than funding the RAB the bank debt is funding liquid assets). When we do this the simple/weighted average of term to maturity at issue of all drawn debt is:

[5] Standard & Poor's, Methodology and Assumptions: Liquidity Descriptors for Global Corporate Issuers, 28 September 2011

[6] PwC, Debt Financing Costs, June 2013.

[7] This is a simple average of each company's weighted average term at issuance for drawn debt.

- 11.4/10.8 years for the original CEG sample of privately owned listed regulated energy companies; and
- 11.0/10.7 years for the original CEG sample plus ElectraNet.

We have also analysed further sensitivities to this analysis.

The first sensitivity analysed is associated with the exclusion of SP AusNet. SP AusNet has some private ownership but its majority ownership is, ultimately, the Singapore Government. The Singapore Government has recently (in May of this year) agreed to sell part of its ownership to the Chinese Government owned SGID – although this sale is not yet complete. It is clear that majority ultimate ownership by the Singapore Government has been positive for SP AusNet's perceptions in credit markets – as evidenced by the announcement by Moody's that SP AusNet's credit rating would likely be downgraded as a result of the sale:

> *The likely downgrade of SP AusNet's rating to A3 would reflect our view that the high likelihood of parental support from SP -- and which has been incorporated in the rating through a 2-notch uplift -- would no longer hold following the divestment to a minority interest.* [8]

If I exclude SP AusNet on the basis that its debt management policy to date is likely affected by its majority Government ownership then the simple/weighted average of the sample rises to 11.5/11.3 years. I also note that the Chinese Government, through SGID, owns 47% of ElectraNet - although I have no evidence of a similar nature to suggest that this minority shareholding give ElectraNet support in credit markets. Nonetheless, I report that also excluding ElectraNet raises the simple/weighted average of the sample to 12.1/11.5 years.

Another sensitivity examined relates to by far the longest dated bond issued by the companies in the sample. This is a 60 year bond ($515m outstanding) issued by APA. This bond is callable 6 years after issue and must pay a 'step up' margin of an additional 1% if it is not called within the first 26 years of its life.[9] The above estimates of average term ascribe a 60 year term to this bond – consistent with the full flexibility it provides APA in the management of its debt portfolio. However, the fact remains that APA can call this bond before 60 years and will be expected to do so within 26 years (before the 1% step up margin must be paid) unless it's perceived credit risk (debt risk premium) worsens by 1% or more.

[8] Moody's investors service. Announcement: Moody's maintains review for possible downgrade of SP AusNet and SPIAA's ratings, August 2013.

[9] APA bond prospectus lodged with ASIC on 9 August 2012.

In light of the above we have included two sensitivities to the above calculations. The first treats the maturity of this bond at 26 years (the date of the first step up margin). The second simply excludes the bond from the analysis altogether.[10] When we:

- treat the APA bond in question as having a maturity of 26 years the simple/weighted average of term to maturity at issue of all drawn debt (treating liquid assets as negative bank debt) is:
  - 10.4/9.9 years for the full sample;
  - 10.7/10.3 years excluding SP AusNet; and
  - 11.1/10.4 years excluding both SP AusNet and ElectraNet.
- exclude the APA bond in question from the analysis the simple/weighted average of term to maturity at issue of all drawn debt (treating liquid assets as negative bank debt) is:
  - 10.0/9.5 years for the full sample;
  - 10.3/9.8 years excluding SP AusNet; and
  - 10.6/9.9 years excluding both SP AusNet and ElectraNet.

In conclusion, based on the complete set of information provided by the businesses, the simple/weighted average term of debt at issuance for energy businesses regulated by the AER with (at least minority) private ownership is 11.0/10.7 years (treating liquid assets as negative bank debt for the purpose of this calculation). This rises to 12.1/11.5 years if firms with substantial Government ownership are excluded.

The lowest estimate of the simple/weighted average term of debt at issuance is associated with including firms with substantial Government ownership and the complete exclusion of the longest dated bond in the sample (the 60 year APA bond). Even this only brings the simple/weighted average term estimate down to 10.0/9.5 years.

[10] A further potential sensitivity would be to assign the first call date as the maturity date for the bond. This would, in my opinion, clearly be wrong. It would amount to assigning a 6 year fixed maturity to an instrument that has a potential maturity of 60 years (i.e., which provides APA with a potential control on refinance risk for up to 60). That is, it would take the bond that offers APA the longest possible maturity in its portfolio and assign it one of the shortest maturities in its portfolio. However, even if this was done the simple/weighted average across all companies, adjusted for cash and cash equivalents, would be 10.0/9.4 years (10.5/9.7 years if SP AusNet and ElectraNet were excluded).

This data strongly supports the original conclusion by CEG that the benchmark term of debt at issuance should be at least 10 years and also supports the 10 year term of debt determined by the AER in the 2009 WACC Review.

Yours sincerely

Dr Tom Hird

Director

Competition Economists Group