GOLDFIELDS GAS TRANSMISSION PTY LTD

ACN 004 273 241
ABN 87 004 273 241

Level 12
Westralia Square
141 St Gorges Terrace
PERTH WA 6000

Telephone: +61 8 6189 4300

Ref: IC – IC – BS: SL 0693

13 April 2022

Ms Jenness Gardner
Chief Executive Officer
Economic Regulation Authority

Dear Ms Gardner

GGT submission on Chairmont's December 2021 report *Debt Raising and Hedging Costs*

On 15 March 2022, the Economic Regulation Authority (**ERA**) published a report by Chairmont Consulting (**Chairmont**) on debt-raising and debt-hedging costs. These costs are the administrative costs and other charges incurred by businesses when obtaining and hedging debt finance. The ERA invited submission on this report.

Goldfields Gas Transmission Pty Limited (**GGT**), operator of the Goldfields Gas Pipeline for the participants in the Goldfields Gas Transmission Joint Venture, appreciates the opportunity to provide the ERA with this submission.

Summary of GGT's submission is, in setting the debt raising and hedging costs:

- Allowance should be made for liquidity fee.
- GGT supports (a) higher offshore issuance costs; (b) allowances for 2nd credit rating and surveillance; and (c) allowance for ISDA[1] costs.
- Scale of transaction should be reconsidered.
- Impacts of environmental, social and governance (ESG) issues on cost of capital should be considered.

[1] International Swap Dealers Agreement.

Background

In the application of the regulatory regime of the National Gas Law and the National Gas Rules in Western Australia, the rate of return on debt is estimated as a hybrid trailing average. The rate of return on debt is calculated as the sum of:

- a base rate for a term of 5 years; and
- a 10 years trailing average of debt risk premiums estimated using the ERA's revised bond yield approach.

This hybrid trailing average is, effectively, a return to lenders determined from current and past financial market data. Such trailing average does not include allowances for the following costs:

- **the debt raising cost**: costs incurred in negotiating and concluding loan agreements with lenders; and
- **the debt hedging costs**: costs of hedging future interest rate movements and exchange rate variations over periods during which regulatory rates of return on debt are fixed.

The two costs are separately allowed for - and are proposed in the Chairmont report.

The GGT's comments on the proposed costs are set out in this letter.

Allowance should be made for liquidity fee

Chairmont's report usefully reviews the types of costs incurred by service providers when raising debt, and hedging, and the allowances which should be made for those costs.

We note that Chairmont explicitly excludes liquidity fees from the types of costs which might be incurred. The reason for this is not clear.

A facility providing liquidity prudently protects against uncertain events which might adversely impact future cash flows. Liquidity facilities are required when bonds are issued. Rating agencies will not rate without facilities providing liquidity being in place.

As such, GGT considers liquidity fees should be included in the types of debt raising costs incurred by service providers.

GGT supports (a) higher offshore issuance costs, (b) allowances for 2nd second credit rating and surveillance and (c) allowance for ISDA costs

In its report, Chairmont proposed:

- higher allowances for offshore issuance costs;
- new allowances for the costs of a second credit rating and surveillance; and
- an allowance (as part of hedging costs) for costs involved in negotiating an International Swap Dealers Agreement (**ISDA**).

These are all consistent with our recent experience that the costs of raising and hedging debt are rising.

Scale of transaction should be reconsidered

The benchmarking of debt raising and hedging costs is, we appreciate, not straightforward. This is because: (a) loan agreements differ across borrowers and lenders; (b) lenders structure their pricing in different ways; and (c) fees vary with the scale of transaction.

GGT's view is that the allowances which Chairmont proposes for debt raising and hedging costs may be too low. This is apparently because the benchmark costs components are fixed (see Chairmont's Tables 2 and 3) for a relatively large benchmark transaction[2]. According to the Chairmont report, the benchmark transaction includes: (a) $250 million in the Australian market; and (b) US$100 million in offshore markets.

An Australian transaction of $250 million, or an offshore transaction of US$100 million, might be a reasonable benchmark for the Dampier to Bunbury Natural Gas Pipeline, which has a capital base of around $3.3 billion. However, it is an inappropriate benchmark for the Goldfields Gas Pipeline, which has a much smaller capital base of around $370 million.

The way in which the scale of transaction impacts debt raising costs requires further investigation before allowances for those costs are set.

We note that the Chairmont report provides no explanation for how the proposed costs set out in Tables 2 and 3 are converted into the specific allowances for 10 years Australian dollar debt, and for 10 years non-Australian dollar debt, in Table 4. Without this explanation, assessing whether the allowances Table 4 are reasonable is difficult. (A similar issue arises in the context of the conversion of the hedging costs shown in Table 7 into the specific allowances of Table 8. The linkage between Tables 7 and 8 should be made explicit.)

Impacts of environmental, social and governance issues on cost of capital should be considered

Chairmont's discussion of the implications of the environmental, social and governance (ESG) concerns for debt raising is, we think, timely.

The report concludes that, at present, these factors do not appear to be having a material impact on debt raising costs. However, as noted by Chairmont, ESG changes are quickly spreading across the world. As such, Chairmont suggested that ESG development should be closely monitored for their impact on regulated rates of return.

GGT is of the view that more than close monitoring is required.

Rather than only closely monitoring, GGT considers the ESG changes need to be considered now for setting the cost of capital for gas transmission assets. This is because of effects of ESG are likely to materialise during the period of the 2022 gas rate of return instrument[3]. Addressing the effects for the next gas of return review (in 2026) is not likely to not enable the ERA to take the required actions in a timely manner.

Our views on ESG issues, and their implications for the financing of investment in gas transmission pipelines, are set out in a short attachment to this submission.

---

[2] That is, debt raised.

[3] That is, between 2023 and 2026 inclusive.

GGT would be pleased to elaborate on any of the views in the submission. If you have any comments or queries, please feel free to contact our Regulatory Manager, Ignatius Chin, on [redacted] or at [redacted]

Yours sincerely

[redacted]

Barrie Sturgeon
General Manager
Goldfields Gas Transmission

Attachment - Environmental, social and governance issues

Increased salience of climate risk in energy infrastructure investment

Discussions with equity investors, and with potential providers of debt, have strongly signalled to GGT that investor perceptions of the risks of investing in energy infrastructure are changing in ways which will impact on the returns those investors require from gas transmission pipelines.

Governments, in Australia and internationally, are responding to climate change with policies which support a shift from electricity generation using fossil fuels, including natural gas, to generation from renewable resources. This shift is being facilitated by technological changes which are making possible low-cost electricity generation from renewables, and which may see hydrogen replace natural gas in a future low-carbon economy. Community expectations are a driving factor in the process of change. Community expectations, technological change, and supportive government policies, now have the potential to provide alternatives to natural gas, and to change the demand for the services of the transmission pipelines which transport that gas. If, in the longer term, natural gas use declines, there may be a corresponding fall in the use of those pipelines, and pipeline assets may be at risk of stranding.

As (a) the effects of climate change and its possible future evolution are becoming better understood (b) new opportunities are emerging from technological change and (c) governments are responding, investor perceptions of the risks of investing in the energy sector are changing. The change in perceptions has become clear since the COP21 Paris Agreement of 2015 and is being attributed, in part, to increased salience of climate risks following that agreement.

As such, effects of climate risk on costs of capital need to be recognised.

Investors concerned about transition risks

Climate risks include both physical risks and transition risks.[4] Physical risks are the risks associated with the possible direct effects of climate change on economic activity (for example, the risks associated with rising sea levels, or with the more frequent occurrence of extreme weather events). Transition risks – the risks about which we are most concerned – are the risks to business models and firm operations associated with transition to a low-carbon economy.

Investors are now concerned about transition risks. They are concerned about the uncertain effects of technological change and climate policies. With greater awareness of climate change and its possible impacts, they are concerned about changing attitudes within the community towards socially responsible investing. Assets may be at risk of stranding in the longer term (physical risk), but investors are now taking into account a range of risks arising in the context of transition to a low-carbon future. Investor perceptions of transition risks are now well documented. Financial economists have begun to ask how these risks are being accounted for in the pricing of equity and debt.

Salience of climate risks (including transition risks) is evidenced by research results

<u>Krueger, Sautner and Starks survey</u>

Late in 2017 and early in 2018, Krueger, Sautner and Starks asked 439 institutional investors about the role of climate risk in investment decision making, and about the implications of climate risk for asset pricing.[5] More than 50% of respondents stated that transition risks related to government policies had

---

4 Bank for International Settlements, "Climate-related risk drivers and their transmission channels", April 2021, page 5.

5 Philipp Krueger, Zacharias Sautner, Laura T. Stark (2020), "The Importance of Climate Risks for Institutional Investors", Review of Financial Studies, 33(3), pages 1067–1111.

already begun to materialise (and less than 10% saw those risks as materialising 10 years or more in the future).

Some respondents saw climate change and policy responses as creating the prospect of asset stranding and lowering the values of their portfolios, but the three principal reasons given for considering transition risks in investment decision making were: (a) protection of investor reputations; (b) moral and ethical considerations; and (c) legal and fiduciary duties.

Most respondents were of the view that current equity valuations did not fully reflect the risks from climate change, although the extent of overvaluation was not large. Moreover, more than half of the respondents that incorporated climate risk into their investment decision making had begun to do so within the last 5 years.

Stroebel and Wurgler survey

From a global survey of 861 sophisticated practitioners and researchers – finance academics, finance professionals, and policy economists – Stroebel and Wurgler drew four main conclusions for climate risks.[6] These conclusions were:

- respondents were at least 20 times more likely to believe that climate risk was currently being underestimated by asset markets as opposed to over-estimated;
- the primary climate risk over the next five years is policy risk along the transition path to a low carbon economy;
- pressure from institutional investors – a consequence of their changing preferences – was, in the short run, the most powerful force for change; and
- most respondents believed that realisations of climate risk were not correlated with economic conditions.

Bolton and Kacperczyk study

In a study using data from the United States, Bolton and Kacperczyk examined the pricing of the shares of firms with higher carbon emissions (including firms with high scope 1, scope 2 and scope 3 emissions).[7] After controlling for other known risk factors, industry conditions and firm characteristics, they found a statistically significant "carbon premium" for all three categories of emissions.

Bolton and Kacperczyk concluded that this premium was an indication of lower investor demand for the shares of companies with high direct or indirect emissions, which translated into lower share prices and, possibly, lower holdings of the shares of high-emissions firms by some categories of investors. Institutional investors, in particular, seemed to be excluding firms to limit the carbon risk of their portfolios. Investors were seeking compensation for their exposures to carbon emissions risks.

Furthermore, the carbon premium had materialised only recently; there was no significant premium in price data for the 1990s.

Bolton and Kacperczyk subsequently examined the way in which corporate carbon emissions, together with country characteristics that reflected likely progress in energy transition, affected the stock returns of over 14,400 listed companies in 77 countries during the period 2005 to 2019.[8] They found:

---

6 Johannes Stroebel, Jeffrey Wurgler (2021), "What do you think about climate finance?", editorial, Journal of Financial Economics, forthcoming.

7 Patrick Bolton and Marcin Kacperczyk (2021), "Do Investors Care About Carbon Risk?", Journal of Financial Economics, forthcoming.

8 Patrick Bolton and Marcin Kacperczyk, "Global Pricing of Carbon-Transition Risk", July 20, 2021. Available at SSRN: https://ssrn.com/abstract=3550233 or http://dx.doi.org/10.2139/ssrn.3550233.

- a statistically significant carbon transition risk premium positively related to both the level of emissions, and to the year-on-year percentage change in the level of emissions, after controlling for characteristics that predict returns;
- this premium was related to both direct emissions from production (scope 1 emissions), and to indirect emissions from firms in supply chains (scope 2 and scope 3 emissions);
- there was a significant positive premium in most areas of the world – North America, Europe and Asia, with the premium in China comparable to the premium in the United States; and
- there was no significant transition premium in the two years preceding the 2015 Paris Agreement, and a highly significant and large premium in the years immediately after that agreement.

Other research

The work by Bolton and Kacperczyk was essentially empirical. Other research has begun to incorporate investor beliefs and preferences about transition risk into ESG-adjusted capital asset pricing models.[9] In these models, investor preference for "green assets", assets which have low impacts on the physical environment, increases demand for those assets and increases their prices, but lowers their returns. A corresponding reduction in demand for "brown assets", assets which have higher environmental impacts, including direct or indirect contributions to the production of significant carbon emissions, reduces the prices of those assets and increases their returns.

Climate risks' impacts on the debt markets

Ginglinger and Moreau found that greater climate risk implied higher spreads on both bank loans and bond issues in the post-2015 period.[10] Their work also suggested that there is a reduction in leverage related to climate risk, which can be attributed to reduced demand for the higher cost debt which banks and bond holders provide to high climate risk firms.

The relationship between the credit ratings and yield spreads of new bond issues by United States corporate borrowers, the environmental profiles of the borrowers, and climate regulatory risk has been investigated by Seltzer, Starks and Zhu.[11] They reported lower credit ratings and higher yield spreads for firms with lower environmental scores, higher levels of carbon emissions, or higher carbon emissions intensities. Furthermore, they found an economically and statistically significant interaction effect on credit ratings and yield spreads of firm environmental profile and the firm's climate regulatory environment. Seltzer, Starks and Zhu observed that the lower credit ratings and higher yield spreads for firms with low environmental scores or high emissions were more pronounced where those firms operated in states with more stringent enforcement of environmental regulation. From this, they concluded that transition risk was an important channel through which environmental profiles affected credit risk.

Consistent with the view that climate risk is now being priced in debt markets, Huynh and Xia found that increased investor demand for corporate bonds which have the potential to provide a hedge against that risk lowers the returns on those bonds.[12] This effect was greater for long term bonds than for short term bonds, suggesting to Hunyh and Xia that investors were concerned about the potential impact of climate change risk being more severe in the longer term.

---

9 Lubos Pastor, Robert F. Stambaugh, Lucian A. Taylor (2021), "Sustainable investing in equilibrium", Journal of Financial Economics, forthcoming. Lasse Heje Pedersen, Shaun Fitzgibbons and Lukasz Pomorski (2020), "Responsible investing: The ESG-efficient frontier", Journal of Financial Economics, forthcoming.

10 Edith Ginglinger, Quentin Moreau, "Climate Risk and Capital Structure", European Corporate Governance Institute, Finance Working Paper No. 737/2021, March 2021.

11 Lee Seltzer, Laura T. Starks and Qifei Zhu, "Climate Regulatory Risks and Corporate Bonds", May 7, 2021. Available at SSRN: https://ssrn.com/abstract=3563271.

12 Thanh D. Huynh and Ying Xia (2020), "Climate Change News Risk and Corporate Bond Returns", Journal of Financial and Quantitative Analysis, forthcoming.

Finance professionals and academic finance researchers are now well aware of the changes we are discerning in debt markets.

Climate risk has more investment decision effects on gas transmission pipelines than electricity networks

Equity investors, banks and bond holders have become aware of the risks associated with transition to a low carbon economy. Furthermore, they have become aware that gas transmission pipelines have high scope 3 emissions, making those transition risks important in pipeline investment decisions.

Equity investors, banks and bond holders currently do not seem to have the same concern for transition risks when assessing investments in electricity transmission and distribution networks. At present, with government policies supporting electrification as a path to a low carbon economy, electricity networks seem to have an assured future.

Effects of climate risk on costs of capital need to be recognised

Investors have not only become aware of transition risks. They are also pricing those risks into equity and debt.

GGT's principal concerns are, then:

- the pricing of transition risk is not currently being recognised in the review of the gas rate of return instrument;
- it is not recognised that gas transmission pipelines have an exposure to transition risk which is different from the exposure of electricity transmission and distribution networks; and
- if transition risk is not recognised now, there will be no opportunity to recognise it during the period of the revised rate of return instrument. This means prices for regulated pipeline service provision will not compensate for the costs of financing the assets used in that service provision before 1 January 2027.