

FACT SHEET

WACC - IPART's New Approach to Estimating the Cost of Debt

April 2014

In the Fact Sheet released on 24 February 2014, IPART proposed to adopt a new approach to estimating the debt margin using credit spreads for Australian non-financial corporations (NFCs) published by the Reserve Bank of Australia (RBA).¹² This Fact Sheet is to inform stakeholders that we will implement the new approach commencing 30 April 2014.

1 Background

On 19 December 2013, the RBA published a method for estimating aggregate credit spreads of Australian NFCs across maturities from 1 to 10 years. The Bank also announced that it would commence publishing the estimated credit spreads monthly from December 2013.³ In our final report on the Review of the WACC Methodology, which we released prior to the RBA releasing its aggregated credit spreads, we indicated our preference for adopting the RBA's series of credit spreads in our WACC estimation.

The RBA's methodology is an extension and improvement on our current approach. The approach used by the RBA is similar to our previous approach in regards to its sampling procedure and approach to converting US bond yields into their Australian dollar equivalents. The RBA's method of sampling bonds also includes additional relevant data points.

Another significant advantage of the RBA's approach over our current approach is that its bond sample achieves an average tenor close to our target of 10 years by:

1. including in the sample bonds with embedded options which tend to be issued with longer maturities, and
2. assigning a greater weight to a bond with a remaining maturity closer to 10 years in calculating credit spreads.

¹ <http://www.rba.gov.au/statistics/tables/index.html>

² IPART, *Fact Sheet - New approach to estimating the cost of debt: Use of the RBA's corporate credit spreads*, 24 February 2014.

³ Arsov, I., Brooks, M., and M. Kosev, *New measures of Australian corporate credit spreads*, Reserve Bank of Australia, December 2013.

Having an average tenor close to our target of 10 years makes it a better proxy for the 10-year debt margin.

Using data readily available through the RBA's website increases the transparency of our WACC determination process.

2 Stakeholder views on the new approach

We received submissions from Sydney Water Corporation (SWC)⁴ and Essential Energy (EE)⁵.

SWC commented that the RBA aggregates BBB+, BBB and BBB- ratings to a single category of BBB which could potentially give a skewed outcome depending on the number of bonds with the 3 different credit ratings in the sample. We noted SWC's submission on this issue. We believe that one of the benefits of adopting the RBA credit spreads is that they are based on a transparent and robust methodology. Our preference is not to make any adjustments to it in order to maintain the transparency and robustness of the estimate.

EE strongly supported using the RBA data and submitted that we should use the new approach when making a final decision for their current review.

3 When will we implement the new approach?

We will implement the new approach⁶ to estimating the debt margin using the RBA data, commencing 30 April 2014.

In the Fact Sheet in February 2014, we proposed to implement the new approach from 1 July 2014, since the consultation on our current 2 reviews⁷, then, had already begun, and this would also allow sufficient time for us to consider submissions from stakeholders on our proposed approach and to hold a workshop, if required.

We did not receive any comments that warranted a revision to the proposed approach or requests to hold a workshop. Hence, we have decided to implement the new approach immediately.

⁴ Email to the Secretariat, dated 3 April 2014.

⁵ Essential Energy submission, IPART's Draft Report of prices for water and sewerage services to Broken Hill and surrounding areas, April 2014.

⁶ For information on how we will implement our new methodology please refer to IPART, *Fact Sheet - New approach to estimating the cost of debt: Use of the RBA's corporate credit spreads*, 24 February 2014.

⁷ The review of prices for Essential Energy's Broken Hill water and sewerage services from 1 July 2014 and the review of prices for land valuation services to councils from 1 July 2014.



4 Further information

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