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Benchmark debt raising costs

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1 Introduction

1.1 Background

1. TransGrid is preparing for its next revenue reset for the 2023-28 regulatory control period, and has asked Frontier Economics to provide estimates of its efficient debt raising costs over that regulatory period.
2. Debt raising costs are transaction costs incurred by network service providers (NSPs) when raising new debt or refinancing existing debt. As the AER has acknowledged, these are costs that any prudent and efficient business would need to incur when delivering regulated services to consumers. Hence, NSPs should be provided with an allowance to recover those efficient and prudent costs.
3. This report:
    a. Provides a brief overview of the AER's approach to estimating efficient debt raising costs;
    b. Reviews recent advice that Chairmont has provided to the AER on debt raising costs, as well as the AER's response to Chairmont's advice; and
    c. Explains the approach we have adopted when estimating efficient debt raising costs for TransGrid and presents our estimates.

1.2 Key findings

4. The AER's approach to estimating efficient debt raising costs has remained largely unchanged since the approach was first developed by Allen Consulting Group (ACG) in 2004. The estimates of debt raising costs for a generic NSP have since been updated by PwC in 2013, Chairmont in 2019 and (in relation to the arrangement fee specifically) by the AER in 2021.
5. In 2019 Chairmont:
    a. Advised the AER that it should change certain aspects of its methodology for estimating efficient debt raising costs. Most of these recommended changes focussed on the approach to estimating the arrangement fee;
    b. Recommended that the AER should use actual cost information collected from NSPs to improve the accuracy and relevance of its estimates of benchmark debt raising costs; and
    c. Updated estimates of each of the components of overall (direct) debt raising costs. These estimates were based on informal surveys of financial market intermediaries.
6. A number of NSPs subsequently made submissions to the AER expressing concerns about Chairmont's estimates of the arrangement fee, which was significantly (i.e., 22 basis points) lower than the estimates previously used by the AER. These submitters argued that Chairmont's estimates lacked transparency, and that Chairmont had misinterpreted the empirical evidence that it presented to corroborate those estimates.
7. In response to these concerns, the AER has decided in its most recent decisions to:

a. not adopt Chairmont's estimate of the arrangement fee. Instead, the AER has undertaken its own analysis to update the arrangement fee using the same methodology used previously by PwC; and

b. adopt all of Chairmont's estimates of the remaining debt raising costs.

8. We agree with that approach.

9. Both PwC and Chairmont have identified that companies that wait until existing debt matures before refinancing that debt would expose themselves to significant refinancing risk. Rating agencies also recognise this, and assess companies with short debt maturity profiles negatively, due to that exposure to refinancing risk.

10. PwC and Chairmont also both conclude that prudent and efficient firms would seek to manage this element of refinancing risk:

    a. PwC has argued that one way to manage this refinancing risk would be for firms to issue new debt at least three months before existing debt matures (in line with guidance issued by major rating agency, S&P).

       This strategy would impose a cost on the business because it would be paying interest on the new debt, but could only invest the surplus funds raised by that new debt at a much lower interest rate. PwC argues that NSPs should be provided with a cost allowance to recoup these efficient and prudent indirect debt financing costs. To date, the AER has not provided NSPs with any allowance for such indirect debt financing costs.

    b. Chairmont argues that an alternative way to manage this refinancing risk would be for businesses to repurchase outstanding bonds 12 months prior to them maturing, with funding from a new (replacement) debt tranche.

       In order to account for this strategy, the AER would simply need to amortise any upfront costs related to 10-year debt over a nine year horizon (rather than the 10-year horizon it currently uses). This change would not result in NSPs being provided with any allowance for indirect debt raising costs. Rather, the change recommended by Chairmont would simply result in more appropriate estimates of direct debt raising costs that reflect an efficient and prudent approach to managing refinancing risk.

11. We agree with PwC and Chairmont that the allowance for debt raising costs should reflect all of the costs incurred under a prudent and efficient debt management approach, including the costs of prudently and efficiently managing refinancing risk. We therefore propose that the AER should adopt Chairmont's recommended approach of amortising upfront costs over nine rather than 10 years.

12. Using estimates of the arrangement fee derived using Bloomberg data to 30 June 2021, and Chairmont's estimates of all other debt raising costs, we estimate TransGrid's efficient debt raising costs for the 2023-28 regulatory period to be:

    a. 9.53 bppa if upfront costs are amortised over nine years; and

    b. 8.79 bppa if upfront costs are amortised over 10 years.

2 The AER's approach to debt raising costs

2.1 The evolution of the AER's approach

13. Debt raising costs are transaction costs incurred by Network Service Providers (NSPs) each time debt is raised or refinanced. The AER has recognised that debt raising costs are "an unavoidable cost of raising debt that would be incurred by a prudent service provider."[1] As such, the AER considers it appropriate to provide NSPs with an allowance to recover an efficient amount of debt raising costs.

14. The AER has historically distinguished between *direct* and *indirect* debt raising costs. The AER regards:

    a. Direct debt raising costs as those costs that arise directly as consequence of issuing new debt or refinancing existing debt, such as arrangement fees, legal fees, company credit rating fees, etc.[2]

    b. Indirect debt raising costs as those costs arising from the management of liquidity and refinancing risks.

15. Currently, the AER only provides allowances for direct debt raising costs. The AER does not provide any allowance for indirect debt raising costs because it considers that the timing of cash flows delivered by the AER's Post-tax Revenue Model (PTRM) provides NSPs with a financial benefit that "fully compensates" NSPs for any efficient indirect debt raising costs they may incur.[3]

16. The approach the AER uses to derive an estimate of efficient direct debt raising costs was first developed for the Australian Competition & Consumer Commission (ACCC) in 2004 by Allen Consulting Group (ACG).[4] The inputs to the ACG method were updated in 2013 by PwC using market data over the period 2008 to 2013,[5] and the AER adopted those updated inputs until they were updated again by Chairmont in 2019.

17. The AER's approach involves:

    a. Estimating a benchmark bond size (currently $250 million);

    b. Estimating the number of bond issues required by a benchmark business of the same size as the NSP to refinance its debt portfolio (i.e., 60% of the Regulatory Asset Base (RAB)) over a 10-year period;

[1] AER, *TransGrid transmission determination 2018 to 2023*, Draft Decision, September 2017, Attachment 3, p. 388.

[2] The exhaustive list of direct debt raising costs allowed by the AER are: arrangement fees, bond Master Program fees, the issuer's legal fees, company credit rating fees, annual surveillance fees, upfront issuance fees, upfront registration costs, annual registration costs and the agent's out-of-pocket costs.

[3] AER, *SA Power Networks Distribution Determination 2020 to 2025*, Draft Decision, October 2019, Attachment 3, p. 16.

[4] ACG, *Debt and equity raising transaction costs*, Final Report, December 2004.

[5] PwC, *Energy Networks Association: Debt financing costs*, June 2013 (the PwC report).

c. Amortising the upfront costs that are incurred in issuing the bonds using the AER's estimate of the NSP's nominal vanilla Weighted Average Cost of Capital (WACC) over a 10-year amortisation period. This estimate is expressed in basis points per annum (bppa); and

d. Multiplying this rate by the debt share of the NSP's forecast RAB to express the estimated debt raising costs as a dollar amount.

2.2 Chairmont's recent advice to the AER

18. In 2019, the AER received advice from Chairmont that recommended a number of changes to the AER's methodology for estimating efficient debt raising costs, including the following:[6]

a. The AER should supplement the information it has relied on historically to estimate efficient debt raising costs (e.g., data collected from Bloomberg) with actual debt raising cost data obtained from NSPs.

b. The AER estimates the benchmark arrangement fee by reference to the typical arrangement fee for a sample of bonds identified using Bloomberg. This fee is then amortised over a 10-year horizon using the AER's estimate of the NSP's WACC.

   Chairmont recommended refining the approach to estimating the arrangement fee as follows:

   i. In addition to the 'Country of Risk' filter used when searching the Bloomberg database for corporate bonds issued by Australian firms, the AER should also use the Bloomberg 'Country of Incorporation' search filter;

   ii. Rather than considering data on all investment grade bonds identified using Bloomberg, the AER should restrict its consideration to bonds with a broad BBB (i.e., BBB-, BBB and BBB+) and A-rated bonds (excluding AAA and broad AA-rated bonds);

   iii. Rather than considering bonds of all maturities identified using Bloomberg, the AER should restrict its considerations to bonds with a tenor of 10 years (+/- 3 years);

   iv. Rather than considering only those bonds with an S&P rating, the AER should expand its sample to also include bonds rated by Moody's and Fitch; and

   v. The AER should use the NSP's allowed return on debt rather than allowed WACC to amortise the arrangement fee.

c. The AER currently assumes a benchmark debt tenor of 10 years, and that debt is refinanced upon maturity of the debt. Chairmont recommends that the AER should instead assume that bonds are repurchased by the issuer one year prior to maturity of the benchmark tenor of debt (i.e., after nine years).

d. Chairmont recommended that one-off costs (i.e., legal fees, credit rating fees and upfront registrar fees) should be treated as operating expenditure rather than being included in the allowance for ongoing debt raising costs.

e. No allowance should be provided for certain costs (i.e., liquidity fees, commitment fees, 3-month facility fees, and the difference between the bond issue price and trading price) sought by some NSPs in recent proposals.

[6] Chairmont, *Debt raising costs*, 29 June 2019 (The Chairmont report).

19. Chairmont also provided estimates of the various components of efficient direct debt raising costs, assuming a $250 million benchmark issuance of BBB 10-year debt by an Australian corporate.

20. These estimates, which are reproduced in **Table 1**, were based on "informal interviews with several financial market intermediaries" rather than the publicly available data the AER has typically used to estimate efficient debt raising costs, or the data that Chairmont's recommendations above related to.

Table 1: Chairmont's estimates of debt raising costs

Cost Item	Estimated Cost	Observation
Arrangement fee	25bps - 35bps x Notional Median: 30bps	No linear relationship between maturity and fee. Includes dealer, arrangement and underwriting.
Legal Counsel - Master Programs	$70k – $150k	Estimates for legal fees varied based on the type of program being documented, domestic or global program.
Legal Counsel - Fees for the Issuer (Dealer Counsel)	$10k - $50k	Described as either once off fee or per drawdown. The lower fee range was for global programs with an annual fee. A domestic program typically has the higher fee which is a one-off fee.
Credit Rating - Initial Credit Rating	$70k - $100k	A once off fee that is paid when the rating is established. This fee is negotiated between the issuer and the rating agency. Most corporates will have two ratings.
Credit Rating - Annual Surveillance	$10k - $20k	An annual fee paid by the corporate for the ongoing surveillance. This fee is negotiated between the issuer and the rating agency.
Credit Rating - Up front bond issue fee	5bps - 10bps X Notional	This fee is paid to the rating agency on each new bond issue. It is negotiated between the issuer and the rating agency.
Registrar - Up front fees	$6k - $20k	A once off fee on establishment. This fee tends to be higher for global programs.
Registrar - Annual fee	$6k - $7k	An annual fee.
Agents Out-of-Pocket fees	$5k - $10k domestic $20k - $50k global	This includes arranger expenses.

Source: The Chairmont report, Table 1, p. 13.

21. It is noteworthy that the estimated arrangement fee of 30 basis points (bp) is significantly lower than the arrangement fee allowance of 52 bp provided by the AER in all regulatory determinations since it adopted the debt raising cost estimates presented in the PwC report.[7] As explained below,

[7] The PwC report recommended an amortised arrangement fee of 8.5 bppa. This translates to an unamortised arrangement fee of 52.3 bp, using the 10-year amortisation period and the notional discount rate of 10% adopted in the PwC report.

much of the criticism of Chairmont's advice to the AER has focussed on the arrangement fee and, in particular, on the lack of sound evidence to support such a material reduction.

2.3 Criticisms of Chairmont's recommendations

22. A number of NSPs have recently made submissions to the AER expressing concerns about Chairmont's recommendations, particularly in relation to Chairmont's estimate of the arrangement fee. These concerns were set out most clearly in an expert report prepared by CEG.[8]

23. CEG's main criticism was the lack of transparency underpinning Chairmont's 30 bp estimate of the arrangement fee. CEG noted that it is unclear:[9]

    a. Which financial market intermediaries Chairmont surveyed and how they were chosen for the survey;

    b. How the survey was conducted or whether the survey was well-designed; and

    c. What the distribution of the survey results were and what statistic Chairmont had used to derive the final 30 bp point estimate.

24. CEG's main point—which we agree with—is that no stakeholder (nor the AER, for that matter) could independently test or verify the basis for Chairmont's 30 bp estimate of the arrangement fee. Chairmont's estimate falls short of the standards of transparency, predictability and replicability set out in the AER's 2018 Rate of Return Instrument,[10] and is therefore unsuitable for the purposes of setting a regulatory allowance.

25. CEG also challenged Chairmont's claim that its 30 bp estimate of the arrangement fee was corroborated by market data, over the period 2008 to 2018, on the arrangement fee associated with issuances of 10-year corporate bonds. CEG pointed out that:[11]

    a. Chairmont had made an elementary (but critical) error in interpreting the data plotted in two line charts with primary (left-hand) and secondary (right-hand) axes. Specifically, Chairmont's conclusion that the data supported an arrangement fee estimate of 30 bp for 10-year bonds was driven entirely (and erroneously) by the scale of the right-hand axes that Chairmont happened to choose for the two charts. Had Chairmont chosen different scales for the right-hand axes, its conclusions would have been entirely different. Since the scale of the axes chosen was essentially an arbitrary choice, Chairmont's conclusions from the data were meaningless.

    b. Proper statistical analysis of the relationship between the arrangement fee and tenor of the bonds suggested that the predicted arrangement fee for 10-year bonds was between 41 bp and 72 bp, depending on whether 'outliers' in the data were included or excluded.

26. Once again, we agree with CEG's conclusions about the shortcomings of the Chairmont analysis.

[8] CEG, *The cost of arranging debt issues*, November 2019 (the CEG report)

[9] CEG report, p. 4.

[10] AER, *Rate of return instrument*, Explanatory Statement, December 2018, p. 21.

[11] CEG report, pp. 5-10.

2.4 The AER's response to Chairmont's recommendations

27. In recent determinations for the Victorian DNSPs, the AER acknowledged that it had received submissions expressing concerns about Chairmont's estimate of the arrangement fee. The AER concluded in those determinations that the Bloomberg data it had previously relied on, rather than on "informal interviews with several financial market intermediaries", is likely to be the most appropriate basis for estimating the arrangement fee:

> *After assessing these submissions, we recognised that Bloomberg is likely to be the most suitable source of information for the 'arrangement fee' at this time because it is the only published source of data known to us and was previously used to estimate the 'arrangement fee'.* [12]

28. The AER went on to confirm that it had updated its estimate of the arrangement fee using the latest Bloomberg data but, in doing so, it had retained the bond selection criteria used in the PwC report rather than the bond selection criteria recommended by Chairmont:

> *Therefore, we have updated the 'arrangement fee' using Bloomberg data and the selection criteria consistent with the PwC report.*[13]

29. The AER also addressed Chairmont's recommendation that it should supplement Bloomberg data with actual data obtained from NSPs, for the purposes of estimating efficient debt raising costs:

> *Since late 2019 we have been reviewing our approach to setting benchmark debt raising costs, informed by actual debt raising costs data obtained from relevant regulated businesses.*
>
> *The initial response to our information request showed that each business has its own system for reporting cost categories with the number and naming of categories differing between businesses. As noted in our draft decision, this makes it difficult to aggregate costs across businesses in order to arrive at an accurate estimate.*
>
> *We have considered whether to continue with further investigation of the industry data. This would entail significant further work. This includes requiring regulated businesses to work with each other*

[12] AER, *Powercor Distribution Determination 2021 to 2026*, April 2021, Attachment 3, p. 11.

[13] AER, *Powercor Distribution Determination 2021 to 2026*, April 2021, Attachment 3, p. 11.

as well as us to reconcile costs to mutually agreed categories. Audit assurance would also need to be considered to ensure that costs have been correctly reconciled and allocated.

Further, we have had regard to the overall magnitude of the debt raising costs (that is, a small proportion of overall opex) and the level of imprecision in our current approach. Based on these considerations, we do not think the benefits of further investigation outweigh the costs. [14]

30. That is, the AER confirmed that due to the disparate ways in which NSPs record and report their actual debt raising costs, and the small magnitude of debt raising costs (relative to overall opex), it would not be worthwhile investigating further whether actual NSP data could be used to estimate efficient debt raising costs.

31. The AER went on to conclude that it would not adopt any of Chairmont's recommendations for estimating the efficient arrangement fee, but that it would rely on Chairmont's estimates for the other categories of debt raising costs:

Therefore, we propose to use our current approach for assessing benchmark debt raising costs—that is, using Bloomberg estimates for the 'arrangement fee' and Chairmont's 2019 estimates for the remaining debt raising costs. [15]

32. We agree with the AER's conclusions above in all but one minor regard—which we discuss in the next section.

[14] AER, *Powercor Distribution Determination 2021 to 2026*, April 2021, Attachment 3, p. 11.

[15] AER, *Powercor Distribution Determination 2021 to 2026*, April 2021, Attachment 3, p. 11.

3 Accounting for prudent and efficient management of refinancing risk

3.1 The debt management approach implicit within the AER's current approach

33. Implicit within the AER's current approach of amortising arrangement fees over 10 years is an assumption that firms wait until a bond they have issued matures, and will then refinance that tranche of debt immediately.

34. In our view, this is would not be an efficient and prudent debt management approach, due to the refinancing risks that issuers would face by following such an approach. A firm that waited until its bonds matured before refinancing would run the risk that debt markets are disrupted or closed at the time they need to refinance their debt. Such a firm may not be able to refinance at all, and this in turn could result in serious consequences for the company, including potential insolvency.

35. The PwC report observed that it is common practice for large corporates to complete refinancing early, before existing debt matures—so as to minimise refinancing risk:

> *It is common practice for large corporate borrowers with multi-million dollar debt programs to actively manage their refinancing requirements. This is most commonly undertaken by completing the refinancing process early and ensuring that the refinanced debt is "locked in" sufficiently in advance of the maturing debt. The credit rating agencies carefully monitor a rated borrower's refinancing strategy with S&P providing explicit guidelines on what it requires from a corporate borrower to avoid undesirable credit rating action.*[16]

36. The PwC report also explained that rating agencies expect companies to complete refinancing of existing debt well before that debt matures, in order to manage their refinancing risks prudently. For instance, PwC quotes the following guidance from S&P:

> *For the Australian investment-grade corporates, we expect to see a measured and logical approach to meet upcoming debt maturities. We would want to see that the company has a credible strategy for repaying or refinancing debt maturing up to 18 months ahead. As maturities move into the forward 12-month time horizon, we will start placing more weight within the short-term rating*

[16] The PwC report, p. 9.

analysis on the materiality of upcoming maturities and the company's refinancing strategy and execution ability. To avoid negative rating consequences, the ideal progression would be:

- *12-to-18 months ahead of maturity, the company would have a detailed and credible refinancing plan (including a contingency plan);*
- *No less than six months ahead of the maturity, the company would have documentation substantially in place for the replacement debt issue/s; and*
- *No less than three months ahead of maturity, the refinancing would be essentially completed, committed, or underwritten.*[17]

37. S&P's rating methodology for corporates explains that the maturity profile of a company's debt is a key factor that informs S&P's credit rating assessments, and that short and compressed maturity schedules for debt would contribute to a negative rating assessment:

A firm's debt maturity profile shows when its debt needs to be repaid, or refinanced if possible, and helps determine the firm's refinancing risk. Lengthier and more evenly spread out debt maturity schedules reduce refinancing risk, compared with front-ended and compressed ones, since the former give an entity more time to manage business- or financial market-related setbacks.

…

While we recognize that investment-grade companies may have more certain future business prospects and greater access to capital than speculative-grade companies, all else being equal, we view a company with a shorter maturity schedule as having greater refinancing risk compared to a company with a longer one.

…

Our assessment of this subfactor is negative if the [weighted average maturity] is two years or less, and the amount of these near-term maturities is material in relation to the issuer's liquidity so that

[17] The PwC report, p. 9-10.

under our base-case forecast, we believe the company's liquidity assessment will become less than adequate or weak over the next two years due to these maturities.[18]

3.2 Debt management approach proposed by PwC

38. Advisers have suggested two different (and mutually exclusive) approaches to managing this component of refinancing risk efficiently and prudently.

39. PwC has proposed (consistent with S&P's guidance quoted above) that an efficient and prudent firm that has issued 10-year debt would issue a new tranche of 10-year debt to replace the original tranche at least three months before the original tranche matures. Under PwC's proposal, the replacement tranche of 10-year debt would not be issued immediately upon maturity of the original tranche. Rather, the replacement tranche would be issued prior to the maturity of the original tranche, with the two tranches overlapping by three months.

40. This debt management approach would create an additional cost to the issuing firm because for the three-month period that the two tranches overlap, the firm would have a surplus of funds (generated by the issuance of the replacement tranche). These funds could be invested at the prevailing cash rate for three months. However, over the same period, the firm would be paying a higher rate of interest on those funds. The difference between the rate of interest on the new tranche of debt and the rate of interest earned by investing those funds at the prevailing cash rate over three months would represent a holding cost to the firm.

41. PwC explains this approach to managing refinancing risk, and the associated cost to the firm, as follows:

Under the above scenario, it is assumed that the borrower addresses its refinancing risk by undertaking the new bond issue 3 months ahead of the existing bonds' scheduled maturity date. As issuers of bonds do not customarily have early redemption / repayment rights under the bonds, the issuer would be required to place the proceeds of the new bond issue on deposit until the old bonds mature. At maturity of the old bonds, the cash from the new bond issue is applied to repay the maturing bonds.

The additional cash cost incurred by the borrower refinancing under this scenario is the difference between:

- *The cost of debt under the new bond issue over 3 months, and*
- *The income generated on the cash investment / deposited for 3 months*[19]

[18] S&P, *Corporate Methodology (General)*, November 2013 (updated in December 2018), pp. 39-40.

[19] The PwC report, p. 10.

42. Some NSPs have proposed to the AER that these three-months ahead bond refinancing costs are an efficient and prudent cost associated with managing refinancing risk that should be compensated through regulatory allowances. The AER has consistently rejected proposals for compensation of these 'indirect' debt raising costs.

3.3 Debt management approach proposed by Chairmont

43. In its advice to the AER, Chairmont also recognises that businesses would face significant refinancing risk if they were to wait until existing debt matures before issuing new debt. Chairmont notes that: [20]

    a. Rating agencies apply greater "penalties" in their rating assessments to firms with short maturity schedules;

    b. In line with Australian market practice, "when planning to refinance a bond, a corporate may seek to re-purchase its own paper from the market";

    c. It is a global convention for "bonds with less than a year to maturity are dropped from the benchmark index"; and

    d. "Chairmont agrees that there are costs of establishing and maintaining a liquidity reserve and financing debt ahead of maturity."

44. Chairmont suggests that one way efficient and prudent firms might manage refinancing risks would be to repurchase their bonds one year before those bonds mature. Consequently, Chairmont recommended that the estimated arrangement fees (and all other upfront costs) should be amortised over nine rather than 10 years:

> *The benchmark should be changed so that bonds are re-purchased 1 year before maturity and an adjustment the debt transaction cost model for the shorter term, i.e. 9 years not 10 years of the bonds being in the market place.*[21]

3.4 Our recommended approach

45. To summarise, PwC and Chairmont:

    a. Both recognise that companies would face refinancing risk if they were to refinance existing debt only upon maturity of that debt;

    b. Both agree that prudent and efficient firms would seek to manage this refinancing risk; but

    c. Propose different ways in which this refinancing risk could be managed—with different consequences for the estimate of efficient debt raising costs.

46. We note that the approaches proposed by PwC and Chairmont are mutually exclusive. If a firm has decided to repurchase its existing bonds one year before they mature (per Chairmont's proposed approach), then it cannot also follow PwC's approach of allowing its existing debt to mature

[20] The Chairmont report, pp. 17-18.

[21] The Chairmont report, p. 17.

naturally and issue replacement debt three months before the existing debt matures. Chairmont recognises this point when it notes that:

> *If the benchmark assumes that [a firm's existing bonds] have been refinanced then there is no need for the commitment, liquidity and 3 month ahead financing debt raising costs to be included in the benchmark.*[22]

47. Hence, in our view, the AER should select one of the debt management approaches suggested by either PwC or by Chairmont as the benchmark efficient approach, and then set the allowance for debt raising costs in line with that approach. As Chairmont notes, the AER should not simultaneously provide an allowance for three-months ahead bond refinancing and an allowance for debt raising costs where upfront costs have been amortised over nine years—as this would effectively provide compensation twice for the same efficient and prudent costs.

48. As noted above, the AER has consistently rejected the approach proposed by PwC. Therefore, we propose that the AER should consider adopting Chairmont's recommendation of amortising all upfront costs (including the arrangement fee) over nine rather than 10 years, when estimating efficient debt raising costs.

49. Adoption of Chairmont's approach would not result in any compensation for indirect debt raising costs. Rather, Chairmont's approach would simply produce better estimates of the debt raising costs that would be faced by businesses that adopt an efficient and prudent approach to managing refinancing risks. In our view, the AER should set regulatory allowances in line with the best possible estimate of efficient debt raising costs. Those estimates should account for efficient and prudent management of refinancing risk, as recommended by the AER's adviser, Chairmont.

[22] The Chairmont report, p. 17.

4 Estimates of benchmark debt raising costs

50. In this section, we present estimates of debt raising costs for TransGrid using the approach that the AER adopted in its April 2021 determinations for Victorian DNSPs, under two scenarios:[23]
    a. Upfront costs amortised over nine years (per Chairmont's recommendation to the AER); and
    b. Upfront costs amortised over 10 years (per the AER approach).
51. The key input assumptions and approaches that underpin the estimates are summarised in **Table 2** below.

Table 2: Key input assumptions and approaches

	Assumption / approach
Opening RAB ($FY2023)	$8,713 million
Benchmark gearing	60%
Discount rate (pre-tax nominal WACC)	4.70%
Benchmark bond size	$250 million
Method for estimating arrangement fee	AER approach – 5 years of Bloomberg data to 30 June 2021
Source of all other direct debt raising cost estimates*	The Chairmont report, Table 1, p. 13

*Source: TransGrid PTRM, Frontier Economics analysis. Note: * Chairmont presents an estimated range for each of these costs. For the purposes of our calculations, we have adopted the midpoint of Chairmont's estimated range for each cost.*

52. Using the inputs and approaches summarised above, **Table 3** shows that the estimated efficient debt raising cost for TransGrid is:
    a. 9.53 bppa if upfront costs are amortised over nine years; and
    b. 8.79 bppa if upfront costs are amortised over 10 years.

[23] The upfront costs that are amortised are the arrangement fee, bond master program, legal counsel – issuer's, credit rating – initial, registrar – up front, agent's out of pocket, credit rating – up front.

Table 3: Estimates of efficient direct debt raising costs

	Upfront costs amortised over 9 years		Upfront costs amortised over 10 years	
Cost category	**1 bond**	**21 bonds**	**1 bond**	**21 bonds**
Arrangement fee	7.79	7.79	7.16	7.16
Bond Master Program	0.61	0.03	0.56	0.03
Legal counsel - Issuer's	0.17	0.17	0.15	0.15
Credit rating - initial	0.47	0.02	0.43	0.02
Credit rating - surveillance	0.60	0.03	0.60	0.03
Registrar - up front	0.07	0.00	0.07	0.00
Registrar - annual	0.26	0.26	0.26	0.26
Agent's out of pocket	0.19	0.19	0.18	0.18
Credit rating - up-front	1.04	1.04	0.96	0.96
Total (bppa)	**11.21**	**9.53**	**10.37**	**8.79**

Source: Frontier Economics analysis.

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