TCorp

New South Wales
Treasury Corporation
ABN 99 095 235 825
Level 22
Governor Phillip Tower
1 Farrer Place
SYDNEY NSW 2000
AUSTRALIA
Telephone (02) 9325 9325
Facsimile (02) 9325 9333
Settlements:
Facsimile (02) 9325 9355
www.tcorp.nsw.gov.au

9 October 2013

Mr Warwick Anderson
General Manager – Network Regulation Branch
Australian Energy Regulator
GPO Box 3131
Canberra ACT 2601

Dear Mr Anderson

AER's proposal to for a 7-year debt allowance benchmark

I am writing to you in response to the AER's Draft Rate of Return Guideline, specifically the AER's proposed shift from a 10-year BBB-plus benchmark to a 7-year BBB-flat benchmark for the cost of debt allowance.

As you will know, NSW TCorp provides loans to the four network businesses in NSW. Collectively, TCorp provides over $18.5bn in loans to Ausgrid, Essential Energy, Endeavour Energy and TransGrid.

The shortening of the debt tenor would have the impact of modestly reducing the cost of debt allowance, while the lower credit rating would have the impact of modestly increasing the cost of debt allowance. Overall, the two impacts would offset one another, leaving the debt allowance approximately unchanged.

Importantly, the proposal would not impact adversely on consumer prices. However, the AER may have overlooked its impact on the way that regulated utilities are financed. That is, privately- and government-owned utilities will seek to minimise uncompensated financial risk by closely matching debt costs to the debt allowance benchmark.

The shift in the AER's benchmark to a shorter tenor will have a direct bearing on the way that perhaps $80-100bn of energy debt portfolios are managed. Empirically, utility debt managers (public and private) have consistently funded to 10 years following the GFC.[1] A 7-year benchmark would create a 3.5-year average life benchmark debt portfolio, funding 20- to 70-year infrastructure assets.

It should be immediately clear that the approach is inefficient[2] and firms might in practice retain 10-year debt tenors at the time of issuance. But in reality, over the last decade firms have repeatedly demonstrated a preference for debt management practices that reduce

[1] Cambridge Economic Policy Associates, Rule Change Sub-Committee of Energy Users Association Australia, Estimating the Debt Margin, October 2011 Final Report, pp. 15-19.
[2] Non-regulated infrastructure businesses typically manage debt portfolios with average residual lives of more than 5 years. The non-regulated infrastructure debt management practices reveal 3.5 residual debt lives as inefficient.

New South Wales
Treasury Corporation

uncompensated financial risk against the regulator's benchmark. In short, the AER's proposed 7-year benchmark would encourage firms to pursue inefficient debt management practices.

A shift to the shorter debt benchmark would likely cause a shortening of utilities' debt portfolios. That is, a 10-year portfolio requires 10% of debt to be refinanced each year, and a 7-year portfolio requires 14.3% of debt to be refinanced each year. Shorter debt tenors increase utilities' (and by extension, consumers') vulnerability to a financial crisis.

The shorter debt tenor would also increase the pressure on the NSW AAA credit rating. By increasing the annual financing requirement on such a large portfolio of loans, the term of TCorp's own annual financing requirement would also rise. In turn, the AER's debt tenor benchmark would make it more challenging to maintain the State's AAA credit rating:

- S&P analyse liquidity, being liquid assets as a proportion of the 12-month financing task. Shorter debt tenors would increase the 12-month funding task, causing a deterioration in the credit metric.
- Moody's analyse the short-term gross debt requirement as a proportion of total debt. AER's proposal to shorten the debt tenor would cause short-term gross debt to rise and the credit metric to deteriorate.

Finally, TCorp recognises the difficulties in credit reference rates that are available to the AER. Over the years, the 10-year credit rate has become difficult to observe because the AUD corporate debt market has become thinner and shorter. TCorp encourages AER to find an independent, credible and Australian-based data provider to publish AUD credit reference rates to resolve the data shortage.

Yours sincerely
New South Wales Treasury Corporation

Stephen Knight
Chief Executive