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Dear Mr Anderson

Return on debt: choice of third party data service provider issues paper

Thank you for the opportunity to make a submission in response to the *Return on debt: choice of third party data service provider issues paper* published in April 2014.

The AER's Rate of Return guidelines propose to use estimates of the benchmark debt yield produced by an independent third party data service provider[1]. TransGrid concurs with this approach and recommends that the return on debt be estimated using yields published by the RBA[2]. TransGrid is also remains significantly concerned about the AER's intention to apply the Rate of Return guideline criteria when making a decision as to which source to use.

The RBA is the appropriate third party data service provider

There are currently only two possible third party data service providers of Australian corporate bond yields, ie:

- the non-financial corporate bond yields for 10-year BBB rated corporate debt published by the RBA; and
- the Bloomberg Valuation (BVAL)[3] curve for 7-year BBB rate corporate debt, which must then be extrapolated to a 10-year yield[4].

There are a number of compelling reasons to use the RBA as the third party data service provider for Australian corporate bond yields. First, the RBA is the only data service provider to publish an estimate of the 10-year BBB yield. The reason that the RBA is able to publish a 10-year yield is that it accesses a richer sample of comparable bonds than Bloomberg, which only samples Australian dollar denominated debt[5].

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1 AER, *Better Regulation – Explanatory Statement Rate of Return Guideline*, December 2013, page 126.

2 RBA, *Statistical Table F3 - Non-financial corporate bond yields.*

3 TransGrid notes that the BVAL curve was first published in November 2013 and replaces the legacy Bloomberg Fair Value (BFV) bond pricing service that is to be discontinued.

4 TransGrid notes that in the AER's most recent decisions the extrapolation of the 7-year yield to a 10-year yield has been achieved through an analysis of 'paired bond' analysis. See AER, *Access arrangement final decision: APA GasNet Australia (Operations) Pty Ltd 2013-17*, March 2013, page 24.

5 Arsov I, M Brooks and M Kosev (2013), 'New Measures of Australian Corporate Credit Spreads', RBA Bulletin, December.

Further, the BVAL 7-year BBB curve must be extrapolated to a 10-year yield. In recent decisions the AER has adopted a range of methods for undertaking this extrapolation, including:

- the use of 'paired bonds' to estimate the debt risk premium increment per annum by reference to pairs of bonds issued by the same corporation with terms close to 7 and 10-years;[6] or
- the use of the last historical spread between the Bloomberg 7 and 10-year AAA rated fair value curves (FVCs), to extrapolate the 7 year debt risk premium estimate to 10-years.[7]

A requirement to extrapolate the 7 year BVAL diminishes a number of the stated advantages of using a third party data service provider because the extrapolation:

- is not undertaken by the third party data provider and is instead produced by either the AER or the regulated entity;
- has the potential to introduce considerable scope for debate, since the choice of extrapolation methodology is contentious;[8] and
- cannot be automatically updated and so must be assessed each time the return on debt is estimated.

TransGrid also notes that the AER has in the past been highly critical of the Bloomberg estimates:

> *'There is evidence to suggest that the behaviour of the Bloomberg fair value estimates since the onset of the GFC is somewhat counterintuitive… [Bloomberg data] implies that prevailing conditions in debt markets are more risky now than during the GFC. This is counterintuitive, as substantial evidence indicates that debt market conditions have improved significantly.'*[9]
>
> *'…without an in depth understanding of Bloomberg's methodology, analysis can only be based on conjecture about how its fair value estimates are derived. Given the limited ability to assess Bloomberg's fair value methodology, coupled with the contrary behaviour of Bloomberg's BBB rated fair value estimates (in comparison to independent market commentary), the AER maintains its position that it should remain cautious of relying solely on Bloomberg's fair value estimates to establish the benchmark DRP.'*[10]

Further, the RBA is a highly regarded institution that is capable of providing high quality econometric data including reliable estimates of the yield on BBB 10-year debt. There is no reason to expect that the RBA would derive estimates of corporate bond yields that are subject to bias.[11]

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6 AER, *SP AusNet Transmission determination 2014-15 to 2016-17: Final decision*, January 2014, page 23.

7 AER, *2012–13 to 2016–17*, August 2012, page 62.

8 The possibility for debate was recognised by the AER when it first accepted the 'paired bond' approach and stated that '[T]he AER considers that all three of the extrapolation approaches have shortcomings, and all three rely on contentious assumptions.' See, AER, *Powerlink Transmission determination 2012–13 to 2016–17: Final decision*, April 2012, pages 184-185.

9 AER, *APT AllGas Access Arrangement proposal for the QLD gas network 1 July 2011 to 30 June 2016*, Final Decision, June 2011, page 37.

10 AER, *APT Allgas Access Arrangement proposal for the QLD gas network 1 July 2011 to 30 June 2016*, Final Decision, June 2011, page 144.

11 The RBA *Code of Conduct* articulates core values including:

The guidelines identify a number of advantages of using a third party data service provider:[12]

- the data are provided for use by market practitioners and developed independently from regulatory processes;
- such providers employ a comprehensive financial database constructed by finance experts that necessarily require the exercise of judgement in terms of data selection and adjustments to yields; and
- such providers reduce the scope for debate on debt yields and can be used to update the return on debt automatically.

TransGrid submits that the estimates of the non-financial Australian corporate bond yields published by the RBA contain these meritorious characteristics. An article published by the RBA at the commencement of this series concludes that:

> *'The estimation method is simple, transparent and robust in small samples. The bank will commence publishing monthly credit spreads from December 2013. The newly constructed credit spread measures will provide richer information than is currently available publicly, allowing the public – researchers, investors, regulators and others – to examine developments in the Australian credit market in more detail.'*[13]

The guidelines also identify a number of potential shortcomings associated with using a third party dataset, including that:[14]

- the third party data service provider may stop publishing data;
- the third party data service provider may stop publishing data at maturities and/or credit ratings that are consistent with the definition of the benchmark efficient TNSP;
- the methodology of the third party data service provider may not be shared publicly; and
- the lack of transparency around the methodology may also reduce confidence in the consistency of estimates over time and between different points of the curve.

- **Promotion of the Public Interest** - We serve the public interest. We ensure that our efforts are directed to this objective, and not to serving our own interests or the interests of any other person or group.
- **Integrity** - We are honest in our dealings with others within and outside the Bank. We are open and clear in our dealings with our colleagues. We take appropriate action if we are aware of others who are not acting properly.
- **Excellence** - We strive for technical and professional excellence.
- **Intelligent inquiry** - We think carefully about the work we do and how we undertake it. We encourage debate, ask questions and speak up when we have concerns.

12 AER, *Better Regulation – Explanatory Statement Rate of Return Guideline*, December 2013, page 127.

13 Arsov I, M Brooks and M Kosev (2013), 'New Measures of Australian Corporate Credit Spreads', RBA Bulletin, December, pages 24-25.

14 AER, *Better Regulation – Explanatory Statement Rate of Return Guideline*, December 2013, page 128.

Having regard to these concerns, TransGrid notes that:

- the RBA has indicated that it will continue to publish estimates of the non-financial corporate bond yields monthly from December 2013, including the yields for 10-year BBB securities;[15] and
- the RBA has been completely transparent and published its methodology for estimating the credit yields.[16]

In contrast, the methodology used to estimate the BVAL is proprietary and so is not transparent. It is not clear which quotes are included (including whether they are appropriate to local conditions) and on what basis. Of some significance, the Independent Pricing and Regulatory Tribunal (IPART) also emphasised the importance of a transparent methodology when it proposed to start using the RBA data to estimate the debt margin for reviews starting from 1 July 2014[17]. In explaining its decision, IPART noted that:

> *'using the RBA's series would further increase transparency of our WACC determination process as data we use to calculate debt margins will be readily available through the RBA's website.'*[18]

However the AER has indicated a concern that the RBA only publishes an end-of-month estimate, ie:

> *'The RBA currently publishes estimates of credit spreads for only the last day of a given month. Dependent on the length of the proposed averaging period, therefore, this may lead to an estimate of the return on debt that reflects short term market fluctuations.'*[19]

This concern is inconsequential if the annual yield is estimated over the full year. Using data from Bloomberg (which publishes daily data), the difference between annual yields using end-of-month as compared with daily data for the Bloomberg FVC for BBB 7-year debt shows that, over the period December 2001 to March 2014:

- the average difference is 0.7 basis points; and
- the maximum difference is 9.4 basis points.

Figure 1 overleaf illustrates the difference between using end-of-month or daily observation to measure an average annual yield.

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15 Arsov I, M Brooks and M Kosev (2013), 'New Measures of Australian Corporate Credit Spreads', RBA Bulletin, December, page 1.

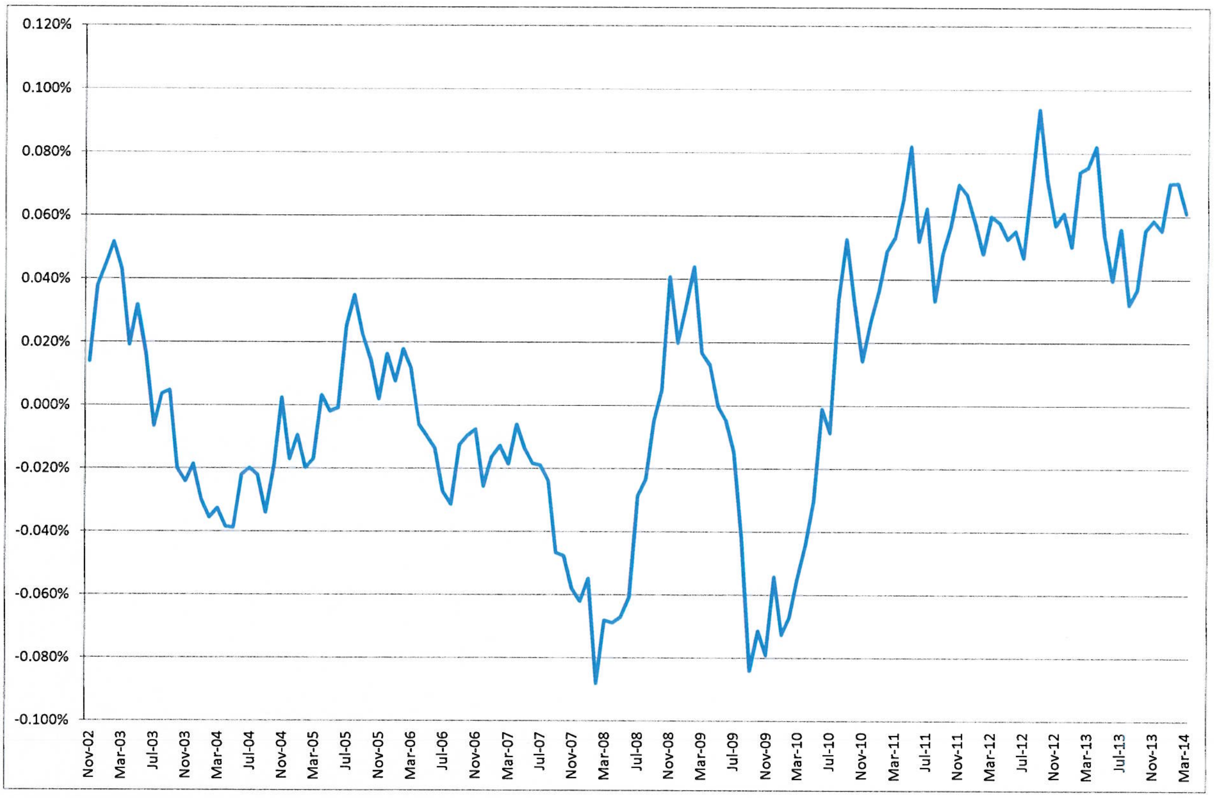
16 See Arsov I, M Brooks and M Kosev (2013), 'New Measures of Australian Corporate Credit Spreads', RBA Bulletin, December.

17 IPART, New Approach to Determining the Cost of Debt: Use of the RBA's Corporate Credit Spread, February 2014, page 5.

18 IPART, New Approach to Determining the Cost of Debt: Use of the RBA's Corporate Credit Spread, February 2014, page 3.

19 AER, *Return on debt: Choice of third party data service provider: Issues Paper*, April 2014, second paragraph section 4.4.6.

Figure 1
Difference between end-of-month and daily estimates of the annual yield (Bloomberg FVC 7-year BBB)



This difference is further diminished when a 10-year trailing average is adopted. Again, using Bloomberg data (ie, FVC for 7 year BBB corporate debt) the difference between the ten-year trailing average using end-of-month as compared with daily data over the period November 2001 to March 2014, shows that:

- the average difference is 0.4 basis points; and
- the maximum difference is 1.4 basis points.

TransGrid submits that a maximum difference of 1.4 basis points between the 10-year trailing average using daily and end of month data is immaterial.[20]

Finally, TransGrid notes that the RBA is likely to further develop its methodology and that this may include the provision of daily data.

Table 1 overleaf sets out again the historical yields on Australian corporate debt of a 10-year maturity and a BBB credit rating.

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20 We note that the AER has stated its intention to round the return on equity estimate to the closest 25 basis points and states that this is immaterial. On this basis a 1.4 basis point difference in the return on debt, which translates into less than 1 basis point difference in the overall WACC, would also be immaterial. See AER, *Better Regulation – Explanatory Statement Rate of Return Guideline*, December 2013, page 65.

Table 1
RBA Aggregate Measures of Australian Non-Financial Corporate Bonds: (10-year BBB Yields)

Number of observations	Year	Average
12	2005	6.31
12	2006	6.79
12	2007	7.72
12	2008	9.91
12	2009	9.72
12	2010	7.90
12	2011	7.81
12	2012	7.06
12	2013	6.98
3*	2014*	6.98
Average		7.72*

* *Indicative rate, based on observations for January 2014 to March 2014.*

In conclusion, TransGrid submits that the RBA data for non-financial corporate bond yields represents the best source of information on the yields for benchmark debt, because:

- it is the only third party data service provider that currently provides an estimate of the 10-year BBB corporate bond yield whereas, in contrast, Bloomberg only produces an estimate of the 7-year BBB corporate bond yield;
- it is the only third party data service provider that discloses the methodology used to estimate the corporate bond yield whereas, in contrast, Bloomberg's methodology is proprietary;
- the RBA calculates the Australian dollar equivalent yield on foreign currency denominated bonds issued by Australian corporations and so uses a richer sample set than Bloomberg, which only samples Australian dollar denominated debt;[21]
- the RBA series appears to perform better than the Bloomberg Australian dollar FVCs in the period during the global financial crisis (GFC);[22] and
- the RBA is a highly regarded institution capable of providing high quality econometric analysis and, for these reasons, its assurance of the continued publication of the 10-year BBB corporate bond yield is credible.[23]

21 Arsov I, M Brooks and M Kosev (2013), 'New Measures of Australian Corporate Credit Spreads', RBA Bulletin, December.

22 See footnote 26, Arsov I, M Brooks and M Kosev (2013), 'New Measures of Australian Corporate Credit Spreads', RBA Bulletin, December.

Use of the guideline assessment criteria is a significant concern

TransGrid continues to have significant concerns about the role and application of the Rate of Return guideline assessment criteria in applying National Electricity and Gas Rule provisions and informing its decision-making functions, including with respect to selecting a third party data service provider in assessing the allowed return on debt.

Use of a second-tier or level of assessment criteria around methodologies and data sources risks obscuring the principal regulatory task of interpreting and applying the operative Rules. It is an approach which involves heightened risk of error, particularly due to the scope for irrelevant considerations to find expression in the interpretation of rule requirements .

As a small practical example of this, the Issues Paper does not systematically examine the requirements and implications of the key National Electricity Rules provisions which define the requirements for a cost of debt estimate (see *National Electricity Rules*, Clause 6.5.2 (h)-(l) and the identical gas provisions). Rather, the paper discusses at length the potential application of assessment criteria which are not in many cases referable to any provision of the rules (i.e. simple over complex).

Some of the assessment criteria, as TransGrid notes the ENA has previously drawn attention to, integrate elements of past National Gas Rules which were amended and removed as part of deliberate rule-making decisions (i.e. a 'well-accepted' criterion acting as a constraint incorporating information provided by alternative cost of equity models). This highlights the potential of assessment criteria to supplant and frustrate, rather than enhance, the task of interpreting and applying the relevant rules.

The actual practical application of the assessment criteria is an additional area of concern, as there does not seem to have been full or systematic consideration given to the potential issues raised under each criterion. This has the result of making the resulting analysis incomplete and anecdotal in nature. An example of this is the application of the final "sufficiently flexible" criteria, which in the Issues Paper is cited as relevant to the question of the frequency of alternative data. However, the same criteria is arguably equally as relevant for other questions raised in the Issues Paper, such as the potential of ensuring a methodology takes into account multiple data sources in a way that is robust over a regulatory period.

Should you wish to discuss any aspect of the above, please contact me on (02) 9284 3148 or anthony.englund@transgrid.com.

Yours sincerely

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Manager Regulation and Business Improvement

[23] TransGrid notes that, in the past, commercial third party data providers have ceased publishing a 10-year BBB yield, with Bloomberg ending its 10-year BBB FVC in August 2009 and CBASpectrum ending its 10-year BBB+ series in August 2010. See: AER, *Victorian electricity distribution network service providers - Distribution determination 2011–2015: Final Decision*, October 2010, pages 490 and493.