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Debt Margin Review
Independent Pricing and Regulatory Tribunal of NSW (IPART)
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Dear IPART

RE: Debt Margin Draft Decision

TRUenergy welcomes this opportunity to provide comments on the "Developing the approach to estimating the debt margin" Draft Decision of February 2011.

The approach to setting the debt margin and other market parameters is very important to TRUenergy. Adopting a predictable and sensible approach will help minimise regulatory risks faced by investors in energy markets covered by IPART. Setting the debt margin at a level that ensures returns do not fall below reasonable market outcomes is essential to give financiers the confidence to provide the investment that the energy industry needs now and into the future.

TRUenergy has some concerns with the data sources and statistical approaches that IPART is proposing to use. However, we note that the Draft Decision only seeks responses on the term to maturity used so we have confined our comments to this area.

IPART is proposing to shorten the term to maturity from 10 to 5 years, and potentially even shorter. TRUenergy contend this is not appropriate for electricity generation or retailing, as outlined in our responses below to the specific questions IPART has asked.

1. Whether there is any further recent evidence on the term to maturity from the funding practices of regulated utilities in Australia?

For businesses such TRUenergy that operate in retailing and generation, the term to maturity for regulated networks is largely irrelevant – the final regulated network tariffs are straight pass through items.

TRUenergy understands that the approach set in the Final Decision on debt margin will be adopted by IPART in setting the weighted average cost of capital (WACC) used in all relevant areas. For the purposes or regulating retail electricity prices, IPART sets WACCs both for retailing and generation.

TRUenergy believes that to argue that by virtue of there being a regulated retail tariff in NSW that a retailer's funding practices should be aligned with regulatory periods is highly unrealistic. Such an assumption may have some merit when applied to the monopoly networks but does not hold in a competitive retail market. Regulatory revenue determinations are only one of many factors shaping a retailer's revenue and cashflows.

For electricity generation, operating in a very competitive wholesale market, the notion of matching funding to regulatory periods that apply to networks or retailers does not make any sense at all.

Investment practice for electricity retailing and generation demonstrates that the regulatory period has no bearing on the term to maturity used in calculating debt margins and underlying debt funding arrangements. TRUenergy recommends that IPART set WACCs for electricity generation and retailing that reflect practices in those industries, not in regulated monopoly ones.

Utilities operating in both regulated and unregulated markets have faced significant funding challenges in recent times. This said, TRUenergy and AGL have both recently issued in to the US Private Placement market for tenors in excess of 10 years. A typical business operating in competitive energy markets will not look to have debt maturing all at once in five years or less. While a portion of debt with maturities in the 3-5 year period is likely to be observed, this is often a consequence of the funding lines available. A portion of debt will come from the bank loan market which currently only lends for maturities of 3-5 years.

A significant amount of longer term debt is available from capital markets – with tenors ranging from 5 to 15+ years, most companies will look to tap this market to extend their debt maturity profile beyond 5 years to around the 10+ years profile. While longer term tenors are generally higher cost, they are essential for security of funding to ensure long term business continuity.

This is consistent with the targeted debt maturity profiles of the three largest non-network private energy operators in the NEM. For electricity retail and generation, recent evidence suggests a term to maturity of less than 10 years is not appropriate. It would be expected that if an arbitrary 5 year term were applied to debt maturities, then expected equity returns would need to be increased to account for this.

2. Whether there is any further relevant evidence on the term to maturity assumption from the practice of other regulators?

TRUenergy is concerned that all of the evidence discussed in the Draft Decision applies to regulated monopoly industries. In particular, the advice of Professor Kevin Davis is predicated on a future cash flow stream which is reset every five years. As outlined above, we do not believe it is appropriate to apply this to businesses that operate in competitive markets.

TRUenergy notes that Frontier Economics' WHIRLYGIG model, the main use for the electricity generation WACC that IPART determines, runs on a 10 year timeframe. Consequently, for electricity generation the logical term to maturity to use would be 10 years.

3. If we shorten the term to maturity assumption, should it exactly match the regulatory period (eg, 1 or 4 years), or should it be 5 years?

As outlined above, in investment practice for electricity retailing and generation the regulatory period has no bearing on the term to maturity of debt funding. To ensure competition, the approach taken by the regulator should ensure that economics of a new entrant generator and retailer are fundamentally supported based on prudent debt management practices. Consistent with the development of the energy cost allowance, a similar approach seems appropriate whereby an assessment could be taken to develop a debt maturity profile for both a generation and retail business assuming no prior debt facilities exist.

However, given the current federal carbon policy uncertainty, it would be difficult for a new entrant standalone generator or retailer to raise relevant amounts of debt for the purpose of developing a debt maturity profile. In this situation it may be more relevant to assess the existing market participants. Based on the incumbents, a term to maturity of 10 years would be a relevant benchmark for developing a debt margin.

4. Whether we should revise the term to maturity assumption for all market-based WACC parameters (ie, the debt margin, the risk free rate and the inflation adjustment).

The term to maturity assumption should be consistent for all market-based WACC parameters. Interpolating a debt margin from an instrument with a different maturity to the underlying base rate and then converting this from a nominal rate to a real rate with an inflation adjustment over an entirely different term to maturity may distort WACC outcomes.

Conclusion

TRUenergy believes that, for the purposes of setting WACCs for electricity generation and retailing, there is no persuasive evidence to support a reduction in the term to maturity from 10 to 5 years. Indeed it would be contrary to IPART's objective of promoting competition (or simulating its effects) to use 5 years when all available evidence suggests a term to maturity of at least 10 years is appropriate for these industries.

Should you wish to discuss any of the issues raised in this submission please feel free to call me on (03) 8628 1120.

Yours sincerely,

Andrew Dillon
Regulatory Pricing Manager