COMPETITION ECONOMISTS GROUP

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Memorandum

To:	ENA
From:	CEG – Asia Pacific
Date:	25 August 2016
Subject:	**Industry debt statistics – response to Contact**

1 Introduction

1. Contact's 4th August submission to the Input Methodology Review proposes the adoption of 6-7bp in compensation for the costs of debt issuance and 3-4bps for the cost of swap contracts to manage interest rate risk. In comparison we have estimated, using data submitted to the Commerce Commission by ENA members, that the average reported cost of debt issuance is around 25-27bp and the average reported transaction costs of swap contracts, including cross currency swaps, are materially higher.[1]

2 Cross-currency swaps

2. For the reasons we set out in our previous memo, we consider that the costs of cross currency swaps must be included in the efficient costs of managing an efficient debt portfolio.[2] Contact does admit that it, just like the ENA members we surveyed,[3] sources its long term debt overwhelmingly in foreign currency markets.[4] However, contact makes no mention of the costs of cross-currency swaps that it incurs as a result.

3. In this regard we note that Contact's 2016 annual report states:

[1] CEG Memo on *Industry debt statistics*, 3 August 2016, sections 6 and 7.

[2] CEG Memo on *Industry debt statistics*, 3 August 2016, section 7.

[3] CEG Memo on *Industry debt statistics*, 3 August 2016, section 5

[4] Contact, 4 August 2016, p. 34.

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Contact manages these risks through the use of interest rate swaps (IRS) and cross currency and interest rate swaps (CCIRS) to ensure that the total debt portfolio has an appropriate amount of fixed and floating rate debt.

4. Notwithstanding that Contact incurs these costs itself as part of an efficient debt management strategy (one that appears to universally require NZ businesses to issue long term debt offshore) Contact does not propose that ENA members are able to recover these costs.

5. Contact does not explain why this is the case but it may be because Contact simply accepts that the Commission has adopted an assumption that all debt is issued in NZD and therefore cross-currency swaps are not required. However, this is not a reasonable position. If the overwhelming evidence from ENA members (and Contact itself) is that:

   - long term debt issuance is efficient (to manage refinance risk); and
   - that this issuance must be made into foreign currency markets due to a lack of demand/liquidity domestically for long term NZD corporate debt; then
   - the regulatory regime must compensate for this efficient cost.

6. This does not necessarily mean that the Commission must use foreign currency bonds issued by NZ firms to estimate the DRP. Doing so may be sensible but is not necessarily critical for the Commission to arrive at a NZD interest rate on debt (which, after all, is the interest rate paid on foreign currency debts after cross currency swaps are entered into). It is, however, critical to include the transaction costs of cross-currency swaps in an estimate of debt management costs. These costs are ubiquitous for the benchmark listed entity managing refinance risk on a large debt portfolio.

7. Given the problems with the Commission's survey request (including that not all firms provided costs for these transactions) one option would be to rely on advice provided by Chairmont to the West Australian Economic Regulatory Authority on the total costs of swaps in managing an efficient debt portfolio. Chairmont proposes costs of 11.5bppa on the following basis.[5]

   Our revised calculation putting the components together is:

   - *5-year swap for full amount of debt = 4bppa x 100% = 4bppa.*
   - *10-year cross currency swaps for 35% of debt issuance = 14bppa x 35% = 4.9bppa.*
   - *10-year fixed-float AUD swaps for 41% of debt issuance = 6bppa x 41% = 2.5bppa.*

5 Chairmont, ERA Hedging Costs in the Cost of Debt, 13 May 2015, p.6.

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> - *No initial swap for the floating-rate debt.*
> - *Rounding to the nearest 0.5bp as for new issuance costs.*
>
> *Based on the above the total hedging cost allowance is 11.5bppa on the full debt portfolio which is very close to the proposed12bppa.*

8. In any event, we strongly endorse Chairmont's advice to the ERA, which was accepted, that:[6]

> *The inclusion of hedging costs into the cost of debt calculation will better reflect the actual costs of managing interest rate risk.*

3 Problems with the Commission survey data

9. It is apparent that the Commission is not using the survey data in the raw form provided to the Commission. This is apparent because the Commission has recently disclosed that its sample for analysing debt raising costs has been updated to include only the 16 bonds shown in Table 3-1 below.

Table 3-1: Commission's bond sample for estimating debt raising costs

Issuer	Issue date	Original tenor (years)	Original interest rate (yield on issue of security) (% p.a.)
Auckland International Airport	7/11/2005	10	7.25
Auckland International Airport	10/08/2009	7	8
Auckland International Airport	17/10/2011	6	5.47
Auckland International Airport	13/12/2012	7	4.73
Auckland International Airport	11/04/2014	3	Floating
Auckland International Airport	28/05/2014	7	5.52
Auckland International Airport	28/10/2008	8.05	8
Auckland International Airport	1/10/2015	3	Floating
Christchurch International Airport	6/12/2012	7	5.15
Christchurch International Airport	4/10/2013	8	6.25
Powerco	20/12/2011	7	6.31
Powerco	20/12/2011	7	Floating
Transpower	15/02/2010	7	6.6
Transpower	30/11/2011	7	5.14
Transpower	4/12/2015	6.6	4.3
Vector	15/06/2012	5	7

Source: Commerce Commision

6 Chairmont, ERA Hedging Costs in the Cost of Debt, 13 May 2015, p.6.

10. However, based on the information we have from ENA members and Transpower, the Airport transaction costs would very likely have to be negative in order for the Commission to arrive at its 6-7 bppa estimate of debt issuance costs. This is not credible.

11. One explanation for this is a calculation error on the Commission's part. Another, more likely, explanation is that the Commission has made some adjustments to the information provided to it. However, the Commission provides no discussion of any such amendments. If such amendments have been made they should, in our view, be consulted on. As things currently stand the Commission is presenting its estimate as derived from the debt survey but it appears that, in reality, the Commission may be substituting its own estimates for the survey.

12. We note that the debt survey request did not provide detailed specifics around what debt raising costs should be included (e.g., credit rating costs, brokerage costs, arrangement fees, roadshow costs, legal cost etc). In this context, it is likely that some costs would be omitted from the responses. It also may be that some responses included costs that were not strictly issuance costs.

13. In this context, we consider that the following options exist:

- Simply accept the current survey responses as accurate;
- Reissue the survey with a more detailed description of the costs to be included and broken down;
- Rely on other non-survey but credible evidence such as the Chairmont report referenced above (in relation to swaps) but including the Commission's own analysis at the last IM review.