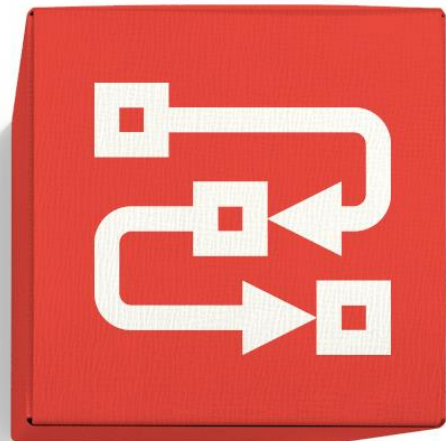


Advice on an appropriate debt risk premium for GAWB's 2020-2025 pricing period: May 2020 update

Queensland Competition Authority

5 May 2020



FINAL NOTE

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1. INTRODUCTION

The Queensland Competition Authority (QCA) engaged CEPA to provide it with advice on the asset beta, capital structure, credit rating, and debt risk premium for GAWB’s 2020-2025 pricing period. Our advice was set out in our report titled ‘*Advice on an appropriate asset beta, capital structure, credit rating, and debt risk premium for GAWB’s 2020-2025 pricing period*’ published on the QCA’s website in February 2020.²

As part of the engagement, we were required to:

Update the ten-year debt risk premium for a BBB-rated entity (or the credit rating later directed by the QCA) for an averaging period occurring in the first quarter of 2020 (to be confirmed at a later stage). Consultants should calculate this using two data sources: RBA data (following the approach in the AER rate of return guidelines) and Bloomberg data (Bloomberg BVAL 10-year BBB rated series), and provide the underlying data.

The debt risk premium (DRP) estimates presented in our 2019 report were based on the 20-business days up to the 30th August 2019. This note provides the updated DRP estimates.

2. DEBT RISK PREMIUM

We have followed the same methodology as set out in Section 5 of our report (CEPA, 2019). For ease of reference, we have set out this methodology in Appendix A. As per our report, we proceed using an S&P BBB rating to estimate the DRP.

The table below provides our estimates of the DRP. For ease of comparison, we have also provided the estimates to 30 August 2019 that were set out in our 2019 report. The risk-free rate for the period to 31 March 2020 was 0.90%.

Table 2.1: Debt risk premium estimate

Date of estimate	RBA (%)	Bloomberg (%)	Average (%)
30 August 2019	2.24	1.88	2.06
31 March 2020	2.67	2.20	2.44

Source: CEPA analysis; RBA; Bloomberg.

² CEPA (2019), *Advice on an appropriate asset beta, capital structure, credit rating, and debt risk premium for GAWB’s 2020-2025 pricing period*, December.

Appendix A **DEBT RISK PREMIUM METHODOLOGIES**

A.1. METHOD USING RBA DATA

To estimate the DRP using RBA data we followed the instructions in the Australian Energy Regulator Rate of Return Instrument.³ The steps required to estimate the DRP using RBA data were as follows:

1. We used linear extrapolation to calculate the exact 10-year term to maturity yield for non-financial corporate BBB-rated bonds.
2. We used linear interpolation to calculate the daily yields for a target term to maturity of 10 years for Commonwealth Government Securities (CGS).
3. We converted the estimated yields in (2) to annual effective rates, assuming semi-annual compounding, and estimated the risk-free rate for the 20-business day averaging period to d 31 March 2020.
4. We used linear interpolation to calculate the daily band spread to CGS as calculated in (2) for our estimates in (1).
5. We converted the estimate in (4) to annual effective rates, assuming semi-annual compounding. We estimated the cost of debt for the 20-business day averaging period to 31 March 2020.
6. We subtracted our estimate of the risk-free rate in (3) from our estimate of the cost of debt in (5).

A.2. METHOD USING BLOOMBERG DATA

To estimate the DRP using Bloomberg data we:

1. Extracted the relevant index from Bloomberg.⁴
2. Calculated the annual equivalent rate assuming semi-annual compounding.
3. Estimated the cost of debt for the 20-business day averaging period to 31 March 2020.
4. Subtracted the estimate of the risk-free rate.

³ Australian Energy Regulator, *Rate of return instrument*, December 2018.

⁴ BVCSAB10 Index – AUD Australia Corp BBB 10Y.



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