QUEENSLAND
TREASURY
CORPORATION

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Dear Sir

Queensland Treasury Corporation's Response to the Review of the Draft Statement of Principles for the Regulation of Transmission Revenues

1.0 INTRODUCTION

Queensland Treasury Corporation (QTC) welcomes the opportunity to respond to the paper released by the Australian Competition and Consumer Commission (the Commission) entitled 'Review of the Draft Statement of Principles for the Regulation of Transmission Revenues' (the Discussion Paper). It has been assumed that in releasing these principles, the Commission is only seeking high level comments at this stage. This response will focus on issues associated with the determination of the Weighted Average Cost of Capital (WACC) and in so doing summarises a number of issues discussed in our response to the Commission's Draft Decision on the Queensland Transmission Network Revenue Cap, which was provided in 2001. We have also limited our comments to areas of primary concern.

2.0 GENERAL COMMENTS

In its submissions to both the Commission and the Queensland Competition Authority, we have highlighted concerns regarding the significant constraints that current regulatory regimes place on these businesses in terms of their ability to effectively manage key business risks. In discharging their responsibilities as providers of essential infrastructure/services in a unique competitive environment, these entities are also expected to operate as viable, commercial businesses. This ensures that the business can deliver value to its shareholders but will also ultimately impact the price and quality of services received by the customer.

All businesses seek to plan and implement strategies in the face of an uncertain environment. These strategies are monitored, reviewed and revised over time as key parameters change. Operating in a regulated environment makes this problematic for regulated businesses given that the key parameters are set at the start of the cycle and the degree of flexibility is extremely limited. At the same time, the need to protect consumers from price shocks is acknowledged. It

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is also acknowledged that balancing the interests of consumers and the network owners can be difficult and that trade-offs will ultimately need to be made in a number of areas.

There are some risks inherent in the framework that can either be managed by the business or the customer. However, there are risks that are exogenous to this system, such as changes in interest rates, inflation or exchange rates. Whilst the current framework does allow for a form of lagged inflation adjustment through the annual CPI indexation of the revenue cap, it does not allow for changes in these other variables.

2.1 Key Difficulties with the Current Framework

Interest rate risk is a key financial risk for any business and certainly in the case where the size of the debt portfolio is significant. The current framework limits the ability to manage this risk for regulated businesses in a manner that is considered appropriate or reflective of risk management practices in a large corporation. To summarise:

- The WACC-setting mechanism exposes the businesses to risks in changes in interest rates within the regulatory period, to the extent that the actual cost of debt exceeds the cost of debt in the WACC set at the start of the period. This relates to not only the risk-free rate but also changes in the debt margin.
- Whilst it is possible to implement a strategy to manage this interest rate risk, it involves a refinancing task that is concentrated in a very short period (ideally corresponding to the risk-free rate reset date/period, to the extent that this is known). This introduces significant refinancing risk to which the organisation would not otherwise be exposed. In a market the size of the Australian domestic market, a refinancing task of this magnitude can lead to market digestion difficulties and even spikes in yields that could impact other participants. Derivatives may therefore have to be used to assist in implementing the strategy and this not only can involve additional costs but also gives rise to counterparty credit risk.
- A diversification strategy, which can assist in managing interest rate, refinancing and liquidity risks cannot be effectively implemented under this regime.
- This also impacts on the funding of future capital expenditure, given that the interest rate applying to any required borrowings is not known until the time of drawdown. This can be hedged at the start of the cycle but only to the extent that the capital expenditure requirements for the term of the regulatory period are known with certainty at that time.

Importantly, an inability to update the WACC during the term of the regulatory cycle can lead to sub-optimal investment decisions.

We maintain our position outlined in our previous submission, which can be summarised as:

(1) consideration of means by which additional flexibility could be introduced to facilitate better management of these risks,

or, if this leads to unacceptable consequences for other regulatory objectives

(2) compensation to these corporations for the inability to effectively manage these risks.

3.0 RISK FREE RATE

3.1 Term to Maturity

We maintain our support for the use of the ten-year Commonwealth Bond Rate as the estimate for the risk-free rate. This is based on consistency with the investment horizon of investors. The Discussion Paper proposes that the use of a ten-year rate inappropriately rewards the corporation for interest rate risk that is not being borne. Further, it is noted that proponents of the ten-year rate view the five-year horizon as inappropriate as it assumes that the regulated assets are sold and re-bought at the end of each regulatory period.

The WACC should provide compensation for the providers of capital (debt and equity) for bearing the risks associated with investing in a corporation in this risk class over the investment horizon. Investors' views do not necessarily coincide with the term of the regulatory cycle. At the same time, refuting the use of a risk-free rate that is consistent with the term of the cycle is not seeking to imply that investors must be seeking to sell and re-purchase their investment at the end of the regulatory period.

When evaluating an investment, investors will consider:

- The risks associated with this asset class; and
- The compensation offered for bearing this risk.

The former will be a key focus and (should) exist independent of the regulatory cycle. The pricing of these risks is normally driven by market forces. If the price is not commensurate with the risk involved, arbitrage opportunities can exist. In a regulated environment, this is more problematic given that the rate of return is set for the term of the regulatory period. Further, in a number of cases the shareholder may be Government and their interest cannot readily be divested. If the regulated WACC does depart significantly from 'market' during the term of the regulatory period, investors may reassess their position however this will not necessarily only occur on a reset date.

3.2 Length of the Averaging Period

It is recognised that averaging over say, a twenty or forty-day period is preferable to a 'rate on the day' approach, as this may 'smooth' some of the volatility present in the market due to short-term influences. As detailed in our 2001 submission, the short selection period poses unique consequences from an interest rate and refinancing risk management perspective, with the most theoretically appropriate strategy being to refinance the entire portfolio over the same period that the risk-free rate is reset. This seeks to ensure that the corporation 'locks in' the cost of debt for the term of the cycle at a rate that closely reflects the cost of debt inherent in the WACC. To the extent that this is implemented, the dates of the averaging period should be known by the corporation (although not the wider market) prior to its commencement.

We continue to have concerns with this for two main reasons:

1. Most regulated businesses are large corporations with sizeable debt portfolios. It is not commercially prudent to have a portfolio with very limited diversification, which is essentially refinanced on or around the period in which the WACC is reset. Businesses of a

similar size and scope in unregulated environments do not have such restrictions and can implement a risk management strategy that is considered appropriate given their objectives. Typically, this will also involve diversification.

Even if a corporation wished to undertake this refinancing task, the difficulties are exacerbated by the relatively small size of the Australian domestic market. There is a relatively limited supply of bonds maturing close to regulatory reset dates, which can also lead to spikes in yields. Pressures on supply will be even more significant where there is a number of regulated entities on a similar cycle under both State and Commonwealth regimes. This is a concern for us for not only our regulated customers, but also other customers who source funding from the same parts of the yield curve.

This limited supply of physical bonds may also mean that derivative instruments are used to achieve the same exposure, which can give rise to an additional cost that is not necessarily reflected in the cost of debt as determined under the regulated WACC, as well as counterparty credit risk. The Commission proposes some compensation for 'debt raising' costs however this would appear to be limited to administration costs rather than market costs.

2. There will be capital expenditure occurring during the regulatory period, some of which will be financed from debt. In unregulated environment, the decision as to whether interest rate risk on future borrowings is hedged upfront is a business risk management decision, and depends on the corporation's appetite for risk as well as the outlook for interest rates. In a regulated environment, corporations do not face this flexibility and are exposed to the risk that the interest rates prevailing at the time of the capital expenditure exceed the cost of debt input in the WACC.

   At the same time, even if the corporations did look to hedge these future requirements at the start of the cycle it is practically difficult to do so. The ability to implement an effective hedging strategy presumes that the amount and timing of these requirements is known with certainty at the start of the cycle. This will not be the case, particularly over a five-year horizon. Uncertain exposures can be hedged with products such as options, however this can be cost-prohibitive, particularly over such long terms. The corporations will therefore be exposed to some interest rate risk with regard to these future capital expenditure requirements.

The use of at least a twenty day average is preferred to the use of shorter term measures, provided the dates of this averaging period are (confidentially) provided upfront, however this still encourages portfolio management strategies that are inconsistent with prudent business practice. It also does not completely remove the risk of short-term shocks influencing the risk-free rate outcome.

Possible solutions

As outlined in our previous submission, a number of alternative approaches could be investigated. The 'ideal' solution is premised on the WACC continuing to represent a 'fair value' price for investments in this risk class.

These include:

(1) A mechanism allowing for WACC adjustments where significant interest rate shocks occur, particularly to the extent that this may represent some form of structural market adjustment. A structural adjustment suggests a revision to what the market considers 'fair value' compensation for investments in this risk class.
(2) A cashflow adjustment for adverse movements in the real rate. This is consistent with the compensation for changes in inflation as an uncontrollable risk. Alternatively, this compensation is provided as an explicit margin that is added to the cost of debt.

We would be happy to work with the Commission to investigate these alternatives.

4.0 DEBT BETA

We are concerned with the use of a debt beta as part of the de-/re-levering process used to determine the cost of equity. A debt beta is a highly theoretical concept, which in itself, does not provide any useful measure of the riskiness associated with the debt. As acknowledged in the paper, the value of the debt beta has little impact on the estimated WACC. There are appropriate alternatives to the Monkhouse formula that do not require a debt beta, such as:

$$\beta_a = \frac{\beta_e}{[1+\{1-t(1-\gamma)\}\frac{D}{E}]}$$

5.0 GEARING

We acknowledge the proposal to benchmark gearing levels to those of a 'regulated firm'. We would, however, have significant concerns if all regulated firms were treated the same and hence the same gearing level was applied across industries. Despite all being regulated, the individual risk characteristics of the relevant industries still do vary. That is, to the extent that the appropriate capital structure is a function of business risk, operating in a regulated environment is only one of a number of relevant risks, albeit a significant one.

The benchmark gearing level should therefore be considered as the level that would be appropriate for a regulated firm operating in that particular industry (eg electricity transmission) but not across regulated firms as a whole.

6.0 CONCLUSION

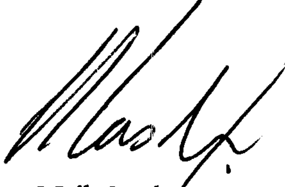
In conclusion, we have significant concerns regarding the restrictions that the current regulatory framework imposes on corporations seeking to manage a range of business risks in a commercially prudent manner. Our particular concerns relate to the determination of the WACC. The selection of the risk-free rate over a very short time period produces unique consequences for the management of interest rate and refinancing risk that can lead to unfavourable outcomes that could potentially impact other market participants. We have proposed that consideration is given to providing for some form of adjustment in the WACC where there is a significant interest rate change, or some form of compensation for being unable to effectively manage these risks in the same way that typical large corporations would seek to do.

The other key concerns we have relate to:

(1) the use of a debt beta
(2) the adoption of a 'blanket' capital structure across all regulated firms, if this is what is intended by the principles.

We appreciate being able to comment on these matters and would welcome the opportunity to discuss them further with the Commission. Please feel free to contact Joanne Blades on 3842 4756 if you have any queries.

Yours sincerely



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