

18 NOV 2004

DATE RECEIVED



Mr E J Hall
Chief Executive
Queensland Competition Authority
GPO Box 2257
BRISBANE QLD 4001

Dear Mr Hall

Thank you for the opportunity to respond to the issues raised in the recent draft determination for DBCT.

In our previous submissions we have detailed our concerns regarding the regime and constraints it imposes on the ability of regulated entities to effectively manage risk. These constraints can have a financial impact in terms of:

- (1) Increased costs, as regulated entities seek to hedge interest rate risk by locking in the cost of their entire portfolio of debt, either physically or through the use of derivatives, during the same short time period over which the QCA determines the regulated cost of debt (ie, the 20-day averaging period). Our customers have indicated to us that they see a real need to minimise the risk of their regulatory and actual cost of debt differing. We are aware of private sector regulated entities that view and manage this risk similarly. However, the approach currently adopted to manage this risk has the potential to result in upward pressure on yields and/or increased costs of derivatives due to the increased demand over the short 20-day time period. The potential for these cost increases arises irrespective of whether QTC or another lender is in the market acting as an intermediary on behalf of these borrowers. Ultimately, any increased cost must be borne by consumers or the asset owner.
- (2) A risk of reduced profitability for the regulated entity if it is not able to effectively hedge all interest rate exposures that occur over the regulatory period. This could occur for example, if the refinancing task was not managed during the actual reset period (because these dates were not known) and/or for new capital expenditure incurred during the cycle.

The DBCT determination has interpreted these considerations as concerns for QTC only, which implies that we bear this financial impact. To the contrary, these issues have no direct

impact on QTC. These costs will be borne by the regulated entity. More importantly, however, they will ultimately be borne by the consumer.

We are not seeking to restate our arguments in detail here. Instead, we have sought to directly address some key points made in the recent draft determination.

Point One:

'The Authority rejects the QTC/Treasury proposal as it appears designed solely to overcome difficulties which arise from QTC's high level of regulated industry debt and the manner in which regulated industries choose to manage risk... This issue is exacerbated by the fact that QTC is the sole supplier of regulated industry debt. Were the debt more widely spread, it is likely that the issues raised by QTC/Treasury regarding the narrow refinancing window etc, would no longer be of serious concern.'

The risks created by the current interest rate setting mechanism will exist independent of QTC's involvement in the process. It is the requirement to refinance the entire debt portfolio within a very short time frame that creates the risks. In particular:

1. The market will be required to digest a large volume of debt over a short period of time. Once the market becomes aware of this activity the interest rates offered may be adjusted higher. These higher rates will ultimately be passed through to the consumer via higher prices.
2. Debt with a particular maturity date will be required as opposed to a diversified portfolio of debt with a range of maturity dates. This substantially increases an organisation's refinancing risk.
3. The 20 day time window does not eliminate the risk of the rate setting occurring at a market extreme.
4. Borrowings for capital expenditure occurring during the regulatory cycle cannot be effectively hedged.

These risks will exist even if multiple intermediaries are used to source the debt. The market impact of the refinancing will not be reduced because each intermediary will still need to hedge their interest rate exposure. It is very unlikely for these exposures to be left unhedged. Although it is possible that some natural offsets may exist it is unlikely for their timing to match that of the rate setting. Additional risks are created by the fact that the regulated entity is required to source debt that best matches the term of the regulatory period if they wish to minimise their interest rate risk. This risk would be greatly reduced if the entity was able to maintain a diversified debt portfolio.

Ultimately it is the market that must absorb the impact of the refinancing, not the intermediaries. If the regulated entity is required to refinance its entire debt portfolio within a short time frame the risks outlined above will remain.

The final risk that is clearly independent of QTC is the treatment of capital expenditure occurring within the regulatory period. The current framework induces an asset owner to

hedge future interest rates during the 20-day averaging period, however this can only be done if both the size and timing of future capital expenditures is known with certainty. The nature of the capital investment decision means that while an organisation will have reasonable long-term forecasts of these requirements, it is neither possible, nor necessarily appropriate, to have complete certainty (let alone in terms of the proportion of this expenditure that would be funded through borrowings). Any unplanned expenditures would have to be funded at the prevailing interest rates, which may be very different to the regulated interest rate. Again, this risk will remain regardless of how the regulated entity chooses to source its debt.

Point Two:

'In terms of the specific refinancing risks, the Authority's view is that, in general, derivative instruments are the natural solution for addressing risks associated with movements in interest rates.'

The use of derivative instruments will not reduce the market impact of the refinancing task. Derivatives can be viewed as a substitute for physical debt, however, the providers of these instruments will still need to hedge their interest rate risk in the market. As a result the risks that were outlined previously would still exist if derivatives were used to refinance part or all of the debt.

Point Three:

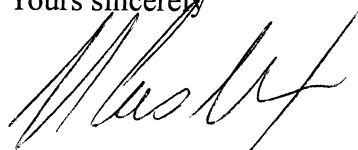
'In the absence of the revenue cap approach '...regulated industries would not be able to minimise their interest rate risk by mimicking the Authority's cost of capital calculations by resetting their interest rates on the same basis and at the same time that the Authority does for cost of capital calculation purposes. They would be forced to manage their risks in a more commercial manner.'


QTC agrees that it is important for the regulated entity to be able to replicate the interest rate setting mechanism in order to minimise interest rate risk. However, it is also important to ensure the mechanism is commercially viable and does not create risks that could otherwise be avoided. QTC has proposed a mechanism whereby the debt refinancing task is evenly spread across the regulatory period. This approach greatly reduces the problems associated with concentrating the entire refinancing to a 20-day period. Because the approach can be replicated the regulated entity will still be able to minimise their interest rate risk. The entity would be able to maintain a diversified debt portfolio and would have a relatively small refinancing task each year.

Non-regulated entities that have to 'manage their risks in a more commercial manner', can similarly choose to minimise their interest rate risk (and implement an appropriate strategy to achieve this) in accordance with their risk management objectives. In QTC's opinion, the regulatory regime exacerbates interest rate risk, rather than minimises it, requiring a commercially imprudent strategy to be implemented to manage both this risk and refinancing risk. Again, this alternative approach is not dependent on QTC's role in the process.

We appreciate being able to comment further on these matters. If you would like to discuss the points raised further, please call either David Johnston on 3842 4782 or myself on 3842 4610.

Yours sincerely

A handwritten signature in black ink, appearing to read 'S. Rochester', written in a cursive style.

 Stephen Rochester
Chief Executive