

Tuesday, 31 December 2002

Mr John Hall
Chief Executive
Queensland Competition Authority
GPO Box 2257
BRISBANE QLD 4001.

Attention: Gary Henry

Dear Mr Hall

re: REVIEW OF THE FORM OF REGULATION OF ELECTRICITY DISTRIBUTION

Queensland Treasury Corporation ('QTC') welcomes the opportunity to comment on the form of regulation for electricity distribution businesses in response to the discussion paper released by the Queensland Competition Authority ('the Authority') entitled "Review of the Form of Regulation of Electricity Distribution" ('the discussion paper').

QTC has previously lodged a submission in response to the Draft Determination issued for these businesses prior to the commencement of the current cycle. That submission focussed on issues associated with setting the Weighted Average Cost of Capital ('WACC'), which is critical to the determination of the revenue cap.

It is understood that the discussion paper released by the Authority is seeking comments on the overall form of economic regulation only and that there will be further opportunity to comment on these issues as part of the preparation of the next Determination. However, it is important to also consider them in the context of the overall framework as the form of regulation will determine the extent to which such issues can be managed.

The Management of Key Business Risks

The overarching objectives of the framework are noted in Section 2.2 of the discussion paper. This includes the implementation of "an incentive-based regulatory regime which will equitably distribute efficiency gains between stakeholders while providing sustainable commercial returns to network owners." To be able to achieve the latter requires the businesses to be able to implement risk management strategies to manage key business risks, in the same manner as any large going-concern corporation operating in a commercial unregulated environment. Such strategies are aimed at ensuring that the business can deliver value to its shareholders. At the same time, the ability to deliver and increase such value 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 limited. At the same time, the need to protect consumers from price shocks is acknowledged. It 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.

The key uncertainty the discussion paper acknowledges is volume risk. Whilst the weighted average price cap and average revenue cap approaches are volume sensitive, the fixed revenue cap approach is independent of this. Under the latter approach, volume risk still exists but is adjusted for through an 'unders and overs' process. This correction mechanism can be used to the extent that revenues either fall short of or exceed the cap due to actual volumes differing from forecast. It is understood that effective management of this risk is a key issue for the current review. However, there are other key business risks that there is currently limited or no capacity to effectively manage.

Difficulties Inherent in the Current Framework

The implication of the options available is that either the customers or the businesses drive risks. 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 doesn't allow for changes in these other variables.

Interest rate risk is a key financial risk for any business and certainly in this case where the size of the debt portfolios is significant. As outlined in detail in QTC's previous submission, the current framework limits the ability to manage this risk for these 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.
- Whilst it is possible to implement a strategy to manage this interest rate risk, it involves a refinancing task that is concentrated in a 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 can involve additional costs.
- 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.

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

One of the objectives noted in the discussion paper is “minimal mid-period adjustments of the revenue or price caps.” A cost-pass through was contemplated in the original determination however the final decision indicated that a review would only occur where information was found to be false or misleading, a material error was made or there is a change in ownership. Interest rate volatility (arising from a number of influences) can lead to the rate being set at levels that may subsequently be viewed as not representing fair value. However, the extent to which the Authority would view this as an ‘error’ is unknown.

At the same time, QTC is not necessarily suggesting that this risk should be fully passed through to consumers. It is also important to ensure that the framework does not protect businesses that have inefficient or inappropriate financial risk management strategies. This could potentially be countered by referencing an appropriate commercial strategy (in the same way that capital structure is determined based on industry benchmarks).

Alternative Forms of Regulation and Financial Risk

As noted above, there is the potential to deal with volume risk in some way under each of the alternatives proposed. If a reasonable correlation existed between macroeconomic variables (such as interest rates) with volume changes, then any means of adjusting for actual volumes could result in a form of natural hedge. However, it would be difficult to see any clear correlation existing. Whilst commercial and industrial electricity demand may have some influences in common with interest rates (ie some relationship with movements in the economy and also inflation), household demand is subject to a range of other influences. Risks such as interest rate and refinancing risk therefore need to be considered as independent of volume risk.

The fixed revenue cap approach potentially provides for compensation for volume risk via the unders and overs mechanism. The average revenue cap approach links revenue to output and will therefore only link to costs that are output related. The weighted average price cap provides for some ability to vary individual prices provided the weighted average price cap is not exceeded. However, given the risks that are the focus of our discussion impact the whole business, it is not appropriate to adjust individual prices in response to this.

If the preferred form of regulation is based on either a revenue or price cap approach, the ability to provide compensation for risks such as interest rate risk would need to see the extension of a ‘side mechanism’ concept, such as the unders and overs approach, to consider these risks.

The hybrid approach has the potential to address this issue via the ability to reflect changes in variable costs. However, QTC acknowledges the difficulties inherent in the hybrid approach, including potentially compromising objectives relating to transparency and administrative difficulties.

Conclusions

To summarise, QTC’s primary concerns with the current framework are based on the very limited ability for the businesses to be able to implement effective financial risk management strategies for key business risks such as interest rate risk. Under this framework, the most appropriate strategy to manage interest rate risk exposes these corporations to unacceptably high levels of refinancing risk. Difficulties in managing interest rate risk for future capital expenditure also remains. This can compromise the ability of the businesses to deliver value to their shareholders, which can also ultimately impact on the

delivery of value to consumers. There is also a concern investment evaluations made during the course of the cycle will reference WACC inputs that are not reflective of current market conditions.

QTC's recommendations are therefore as follows:

1. The ability to manage key business risks is not adequately dealt with under the current regime, nor has it been contemplated in the discussion paper. It is therefore recommended that consideration is given to extending the regulatory principles to include enabling the businesses to implement effective risk management strategies in accordance with prudent risk management practices appropriate for large commercial corporations.
2. The ability to effectively manage risk implies providing the businesses with flexibility and there is the potential to do this in different ways under the alternative forms of regulation proposed. This flexibility could therefore take a number of forms, such as:
 - (1) The ability to review prices to reflect unanticipated changes in variable costs beyond those relating to volume. This may be on a full or partial 'glide path' basis.
 - (2) The ability to update key WACC assumptions under pre-agreed parameters (for example, where changes in the market suggest some form a structural adjustment). This does assume that the initial assumptions represent 'fair value' and this in itself will need to be addressed.

Alternatively, this may take the form of a cashflow compensation, in recognition of the limited ability of these businesses to effectively manage risks in a regulated environment.

QTC's primary objective in this submission is to highlight the need for these businesses to be able to effectively manage risks in a volatile and competitive environment. In so doing, there are a number of issues that would need to be worked through in considering the means by which this could potentially be addressed. QTC would therefore welcome the opportunity to discuss this further with the Authority. Should you have any questions with regard to this submission in the meantime, please contact JoAnne Blades (3842 4756).

Yours sincerely

Stephen Rochester
Chief Executive