QUEENSLAND
UrbanUtilities

Office of the Chief Executive Officer
Level 3, 15 Green Square Close
Fortitude Valley
Brisbane QLD 4006
GPO Box 2765
Brisbane QLD 4001

24 April 2014

Dr Malcolm Roberts
Chairman
Queensland Competition Authority
Level 27, 145 Ann Street
BRISBANE QLD 4000

Emailed to: research@qca.org.au

Dear Dr Roberts

Trailing Average Cost of Debt – Issues Paper

Thank you for the opportunity to provide a submission in response to the Issues Paper on the concept of the trailing average cost of debt. Given the debate regarding this parameter in other jurisdictions, we consider it to be an important aspect of the weighted average cost of capital (WACC) calculation that warrants consideration within the Queensland Competition Authority's (QCA's) industry-wide cost of capital review.

There are two key messages that Queensland Urban Utilities would like to convey through this submission:

1. Adopting a trailing average cost of debt would be more consistent with an efficient debt management strategy in the absence of regulation, and
2. Under a light-handed framework the QCA could nominate appropriate methods for calculating WACC parameters rather than prescribing a specific WACC value

In the absence of regulation, it would be reasonable to assume that a business would adopt a debt portfolio with varying maturities to limit the business' debt risk exposure. By adopting such an approach for the benchmark cost of debt it reduces the potential for mismatches between the regulated cost of debt and efficiently incurred debt financing costs that would occur in a competitive market.

Cont'd/.....

ABN 86 673 835 011

Queensland Urban Utilities considers that where the regulatory regime is more monitoring related and a lighter-handed framework, the QCA could nominate appropriate methods for calculating WACC parameters rather than prescribing a specific WACC value. The regulated businesses would then outline the WACC that they have used in setting their prices and how this WACC estimate complies with the nominated methods from the QCA. Given that the responsibility for setting prices under a light-handed framework rests with the businesses, it is important that the businesses then "own" the WACC estimate (subject to appropriate methodologies).

A secondary benefit of adopting the trailing average approach is a reduction to the saw-tooth like volatility that can occur at the end of regulatory periods. This results in a more stable cost of debt allowance over time and a reduction in potentially significant price volatility for customers.

In responding to the Issues Paper, we have used the consultation issues that were outlined throughout the document. Where appropriate we have referred to the submission from the Queensland Treasury Corporation (QTC) for further details.

> *3.1 – Please comment on the possible advantages and disadvantages of the QCA adopting a trailing average cost of debt approach rather than the current 'on the day' approach to determining the regulatory cost of debt.*

The primary advantage of adopting a trailing average cost of debt concept would be that regulated businesses could structure their debt portfolio similarly to how an unregulated commercial business would structure its debt portfolio and reduce the risk of mismatch between actual and benchmark debt costs. Additionally this debt portfolio structure would allow for regular debt refinancing which would reduce the businesses refinancing risk as well as smoothing out the volatility of debt pricing driven by relatively short lived economic events.

Further details on the possible advantages of the trailing average cost of debt approach can be found in the QTC submission to the Issues Paper.

> *3.2 – How should the QCA address the potential problems that arise from implementing a trailing average cost of debt approach, in particular potential overstatement of the allowed cost of debt and complexity in implementation of the trailing average cost of debt?*

Queensland Urban Utilities agrees with the QTC submission that there is no demonstrated evidence of an overstatement of the cost of debt through the use of a 10-year trailing average of 10-year debt yield.

One of the aspects to consider in using shorter term debt and refinancing is the requirement to refinance more than 12 months out from maturity. This is required to ensure that the debt does not become "current" for accounting purposes and potentially result in a business becoming technically insolvent. Therefore the use of a shorter debt maturity would require refinancing earlier than the maturity and subsequently more frequent transactions.

Cont'd/.....

Issues regarding the trailing average approach potentially adding to the complexity of the regulatory approach appear to be overstated. A simple spreadsheet model has already been developed by the QTC and is available for use. The idea that an estimation technique for a particular WACC parameter not be incorporated due to a perceived increase in complexity does not hold when you consider the different approaches used to estimate other parameters such as Beta and Gamma

> *3.3 – Are there any other issues for stakeholders that the QCA should consider as part of deciding to adopt a trailing average cost of debt approach?*

The methodology used to estimate the cost of debt should be reflective of an efficient debt management strategy that would be expected of a business operating in the absence of regulation. Furthermore, the estimation of the cost of debt should not be impacted by arbitrary factors such as the length of the regulatory period. This simply distorts the debt management of a regulated business and does not reflect how a competitive business would manage its debt portfolio.

The appropriate use of the trailing average cost of debt approach will also lead to a reduction in the price volatility that can occur to customers at the change of regulatory periods under the current approach.

> *4.1 – Are there any issues that need to be considered in applying the PwC estimation methodology to derive the prevailing cost of debt for the benchmark firm each year under a trailing average cost of debt approach?*

The primary issue to consider is the transactional costs involved in determining the estimated cost of debt. Under a light-handed framework this would be a decision for the business to decide if the transactional costs involved with this estimation methodology warrant the use of the trailing average approach. The regulated business would then demonstrate to the QCA how the estimate is consistent with the methodology guidance. This should then eliminate the need for the QCA to also undertake the estimation and therefore additional cost to the process.

> *4.2 – If the QCA were to adopt a trailing average approach, should the average apply to the entire benchmark cost of debt or to the debt risk premium component only?*

Queensland Urban Utilities would prefer that the trailing average apply to the total cost of debt rather than the debt risk premium component only. Only applying a trailing average to the debt risk premium still requires a business to use swaps to lock in a fixed base rate for its entire debt balance for the regulatory period.

Further details on the preference to apply to the total cost of debt can be found in the QTC submission to the Issues Paper.

> *4.3 – Should the QCA consider making annual adjustments to the regulatory cost of debt? If so, how should the QCA address the issues relating to annual adjustments?*

Cont'd/.....

The use of annual adjustments to the regulatory cost of debt will lead to a better match between the allowed cost to that actually incurred, therefore the annual adjustment is preferred.

If a light-handed framework is in place that requires the regulated businesses to control their own prices, and in essence their own WACC estimate, the decision to make annual updates becomes the business' decision. This will mean that any impacts from the annual adjustments would be managed by the business.

One potential option under this light-handed framework scenario would be for the QCA to provide an annual benchmark cost of debt using the trailing average methodology. At the commencement of the framework, the businesses would be required to make a decision as to whether to accept the QCA benchmark cost of debt, or adopt their own calculation subject to nominated methodologies.

> *4.4 – What are the advantages and disadvantages of applying a weighted, rather than simple, average under a trailing average cost of debt approach?*

The primary advantage of applying a weighted trailing average cost of debt is due to it being more reflective of the actual debt portfolio used by the business i.e. new debt is not drawn in equal amounts each year.

Further details on the advantages of a weighted approach can be found in the QTC submission to the Issues Paper.

Queensland Urban Utilities is also aware of QTC providing a worked example in its response to this Issues Paper. This example can be used as a template for how to apply the weighted average and thereby reduce any perceived complexity.

> *4.5 – What is the most appropriate data source and weighting approach for minimising the potential mismatch between the allowed and actual cost of debt without distorting incentives for regulated firms to seek to achieve an efficient debt policy?*

Queensland Urban Utilities considers that the use of the regulatory asset base (RAB) in the current benchmarking approach to calculating the cost of debt allowance to be appropriate. Further details on this position are contained in the QTC submission to the Issues Paper.

> *4.6 – What are important considerations when developing transitional arrangements that ensure regulated firms and customers are not adversely affected?*

While it is important to understand how a new methodology would be transitioned to, the transition arrangements of a preferred methodology should not impact on the decision of the overall preferred methodology. The primary consideration for any transition arrangements would be to ensure that any financial impacts of the arrangements are minimised.

Cont'd/.....

Transition methodologies have been developed through the Australian Energy Regulator (AER) WACC review that ensure businesses cannot "cherry-pick" their preferred methodology for each regulatory period depending on the market conditions at the time.

> *4.7 – Should the QCA apply a single cost of debt approach across all regulated firms, or should it determine the most 'efficient' benchmark for a given regulated firm on the basis of certain, firm-specific parameters?*

As outlined further below, Queensland Urban Utilities considers that consideration should be given to the different frameworks that the QCA operates. For those light-handed frameworks where the regulated business is responsible for the setting of prices, the setting of the WACC should be the responsibility of the regulated business, subject to nominated methodologies from the QCA.

> *4.8 – Should the QCA consider allowing different regulated firms to choose the cost of debt benchmark approach that they prefer (subject to certain pre-specified limitations)?*

In a light-handed framework, if the regulated business chooses to adopt a more complicated approach (such as the trailing average) for its cost of debt to more closely align with its actual cost of debt, the regulatory framework should not preclude the business from doing so.

Where the businesses are responsible for setting the prices, the QCA needs to be mindful of being too prescriptive in the setting of the WACC – thereby giving no alternative but to adopt a "QCA WACC" – as the QCA may inadvertently be seen as implicitly having a hand in the setting of prices within the light-handed framework. Queensland Urban Utilities considers that ideally, under a lighter-handed framework, the QCA would nominate methodologies for determining the WACC parameters (such as the cost of debt), with the decision on which approach left to the regulated business.

If you have any questions or concerns with this submission, please contact Tim Ryan on 3855 6161 or Tim.Ryan@urbanutilities.com.au.

Yours sincerely

LOUISE DUDLEY
Chief Executive Officer
Queensland Urban Utilities

CC. Mr George Theo, Chief Executive Officer, Unitywater
Mr John Fallon, Director, Queensland Competition Authority