Queensland Government

Treasury

Our Reference: TRX-12849

21 MAY 2010

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

Dear Mr Hall

Thank you for the opportunity to comment on the Authority's draft decision with respect to the Gladstone Area Water Board (GAWB) 2010 price reset.

The main issue for Treasury Department (Treasury) is the Authority's proposed use of a five year term for the risk free rate and debt risk premium, in estimating the weighted average cost of capital (WACC) to apply for GAWB for the 2010 to 2015 period.

On this point it is noted that the Authority's decision on these parameters for GAWB will be largely informed by its findings in respect of the same parameters for the 2009 Queensland Rail (QR) access undertaking. Treasury has previously provided a submission on the QR WACC parameters.

In summary, Treasury disagrees with the use of a five year term for the risk free rate and debt risk premium on the basis that:

- it is inconsistent with demonstrated regulatory precedent as set in recent determinations for regulated businesses, creating regulatory uncertainty;
- it penalises a regulated business for seeking long term borrowings as a means of managing refinancing risk; and
- the difference between five and ten year bonds is not material as claimed by the Authority.

Executive Building
100 George Street Brisbane
GPO Box 611 Brisbane
Queensland 4001 Australia
Telephone +61 7 3224 2111
Facsimile +61 7 3221 5488
Website www.treasury.qld.gov.au
ABN 90 856 020 239

i) Regulatory Precedent

There are strong regulatory precedents in using a ten year term for the risk free rate and debt risk premium, to set regulated rates of return. Recent precedents include:

- the Australian Energy Regulator's May 2009 review of WACC parameters for electricity transmission and distribution network service providers; and
- the Australian Competition and Consumer Commission's draft decision for the Australian Rail Track Corporation Hunter Valley coal network undertaking.

Standard regulatory practice is overwhelmingly in favour of the use of a ten year term for estimation of the risk free rate and debt risk premium. This is the method by which a benchmark WACC will be assessed by other regulators, and indeed is the way the Authority has previously applied to the WACC. It is also the benchmark investors are likely to look at as the opportunity cost of capital for regulated businesses. Given GAWB competes against other businesses to attract scarce investment capital, Treasury considers that it should be provided with a competitive WACC that differs only according to the specific business risks of the individual entity.

The predictability of regulatory decisions is an important variable for investors in their investment considerations. The Authority's changing of a previously accepted regulatory parameter adds to the perceived risk of the business, and could result in reduced investment if returns are considered inadequate to justify the level of risk.

ii) Additional refinancing risk

As a regulated business, GAWB is expected to manage its risks in a commercially prudent manner. In this regard the Authority has not given adequate consideration to the implications of its decision on GAWB's ability to manage its borrowings.

Put simply the QCA's decision forces the regulated business to make a choice between:

- the greater refinancing risk associated with matching borrowings with the term of the regulatory period; or
- the high transaction costs associated with borrowing long dated bonds and hedging the interest rate exposure.

Treasury supports the view that the benchmark regulated business will seek to borrow long maturity bonds as a means of reducing refinancing risk. If the regulated business were to structure the maturity dates of its borrowings to match the term of the regulatory period, the concentrated debt portfolio that would eventuate would require more regular refinancing. The increased refinancing exposes the business to increased volatility in bond yields and greater refinancing risk, signalling to the market to increase the cost of debt. The use of longer dated bonds can mitigate these risks by diversifying the regulated businesses exposure across the yield curve. Despite the term structure of bond yields in which longer term debt is usually more expensive, the total risk adjusted costs are often minimised by issuing at the long end of the yield curve.

If GAWB chooses to borrow long dated bonds it will still need to hedge its interest rate exposure to achieve a cost of debt commensurate with the regulated cost of debt proposed by the Authority. However by synthetically hedging this exposure, it will incur transaction costs for which it will not be compensated. If the Authority does continue with the position taken in the draft decision, these hedging costs should be classified as operational expenditure and recovered through regulated revenues.

iii) Long average for the credit spread between five and ten year bonds

The Authority identifies a major reason for adopting a five year term is the materiality in the spread between yields of five and ten year Commonwealth Government bonds. Treasury would recommend consideration of a long term sample of bond yields in estimating this difference, to account for the possibility of outliers in the Authority's sample period. If observations from a small sample containing outliers are used to justify the move to a shorter term for the risk free rate and debt risk premium, this may result in significant under-compensation for the regulated business.

Evidence presented by the Queensland Treasury Corporation (QTC) to the Australian Energy Regulator in February 2009 demonstrates that the long term average of the term premium between five and ten year yields for Commonwealth Government bonds is in a range of 0.10 to 0.15 per cent. Further QTC argued that this difference had been declining for several years since 1994.

More recently spreads in yields between five and ten year bonds have exhibited significant volatility relative to historical norms. The spread between five and ten year Commonwealth Government bonds reached a maximum of 0.84 per cent on 2 February 2009. Since then yields have converged significantly, with the spread estimated at 0.19 per cent on 6 May 2010, just outside the high end of the long term average estimated by QTC.

The use of a small sample to argue for a shorter term for the risk free rate can lead to significant under-compensation and mismatch in the forward years of the regulatory period. Treasury suggests the use of longer term data may mitigate the risks with this approach.

Concluding Comments

In view of the above, the Authority's draft decision on the term of the risk free rate and debt risk premium warrants revisiting. Treasury considers that the decision should be revised taking into account the strong regulatory precedents in this area, the prudent debt management practices of GAWB and the immateriality between five and ten year Commonwealth Government bonds.

If you would like any further information, please contact Ms Tania Homan, Director Economic and Structural Policy, on (07) 3224 2806 or tania.homan@treasury.qld.gov.au.

Yours sincerely

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Gerard Bradley
<u>Under Treasurer</u>