

Updated cost of debt estimates for Seqwater

PRESENTED TO: SEQWATER

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1 Background

- Queensland Treasury Corporation (QTC) has been asked by Seqwater to produce cost of debt estimates for FY19–FY28.
- The estimates will be used in Seqwater's submission to the Queensland Competition Authority (QCA) regarding the bulk water price to apply from 1 July 2018.
- QTC understands that the QCA will update the price path to allow Seqwater to recover:
 - a rate of return on the regulated asset base (RAB), and
 - interest on the price path debt.
- The interest rates used by the QCA to determine the rate of return and the interest on price path debt are to be based on QTC's estimates of Seqwater's cost of debt.
- The QCA's initial pricing period will be FY19–FY21.

2 Seqwater's debt facilities

- Seqwater has two Portfolio-Linked Loans (PLL) from QTC:
 - Water Infrastructure Debt (WID) PLL, and
 - Water Grid Manager (WGM) PLL.
- The funding portfolio that QTC uses to provide the WID PLL is comprised of a diversified mix of fixed-rate debt instruments with staggered maturity dates and an average duration of about 6.5–7.0 years.
 - The average duration is maintained by progressively refinancing short-term debt, which makes up a relatively small percentage of the total funding, with new long-term debt.
 - The interest rate on the WID PLL is appropriate to use in the calculation of Seqwater's rate of return.
- The funding portfolio that QTC uses to provide the WGM PLL is currently comprised of six fixed-rate debt instruments with an average duration of about 6.5 years.
 - The interest rate on the WGM PLL is appropriate to use to determine the interest on price path debt.

3 Estimating the cost of debt

3.1 Water Infrastructure Debt

- The cost of debt for the WID PLL has been estimated by simulating the annual refinancing transactions required to maintain an average funding duration of about 6.5 years.
- QTC has used two 'forecast free' scenarios to estimate the long-term interest rates to apply to the future refinancing transactions:
 - *Scenario 1:* The long-term QTC rate remains unchanged at its current value of 3.15 per cent until 2028.
 - *Scenario 2:* The long-term QTC rate changes annually based on the implied forward yield curve.
- These scenarios represent different ways of using observable market data (rather than forecasts) to estimate the annual WID PLL cost of debt.
- QTC considers both approaches to be reasonable for the purpose of estimating Seqwater's cost of debt. As such, the estimate in a given year equals the simple average of estimated cost for that year under Scenario 1 and Scenario 2.

3.2 Water Grid Manager Debt

- QTC's most recent liability benchmark review for Seqwater indicated that the duration of WGM PLL funding portfolio should be lengthened to about 6.5 years. The Seqwater Board approved QTC's recommendation, and the lengthening transactions were performed in early July 2017.

3.3 Cost of debt estimates

- The cost of debt estimates are shown in the Table 1. The estimates include QTC's administration fee and are expressed on an *annual effective* basis.

TABLE 1: ANNUAL EFFECTIVE COST OF DEBT ESTIMATES

| Financial year | WID PLL (%) | WGM PLL (%) |
|----------------|-------------|-------------|
| 2018–19 | 5.50 | 5.11 |
| 2019–20 | 5.25 | 5.11 |
| 2020–21 | 5.10 | 5.11 |
| 2021–22 | 4.95 | 5.11 |
| 2022–23 | 4.80 | 5.11 |
| 2023–24 | 4.70 | 5.11 |
| 2024–25 | 4.65 | 5.11 |
| 2025–26 | 4.60 | 5.11 |
| 2026–27 | 4.55 | 5.11 |
| 2027–28 | 4.55 | 5.11 |

4 Additional considerations

- The actual WID PLL cost of debt will depend on factors such as:
 - the actual amount of refinancing performed each year
 - the long-term QTC rate at the time of each refinancing transaction, and
 - any other changes to the duration and/or composition of the WID PLL funding portfolio.
- Although these factors will produce differences between the actual and estimated debt costs used in the rate of return, QTC understands that, subject to a decision of the Government at the time, any differences in the period FY19–FY21 will be true-up in the prices to apply post 30 June 2021.
- Similarly, additional changes to the duration and/or composition of the WGM PLL funding portfolio will cause the cost of debt to change. It is unclear if a similar true up mechanism will apply to interest on price path debt.
- The QCA is expected to publish its final report in March 2018. Changes in QTC market rates between the date of this advice at the date of the QCA's report may affect the cost of debt estimates for the WID PLL, however the impact of the changes should be relatively small for the initial pricing period (ie, FY19–FY21).
- If a large change in market rates does occur, QTC recommends exploring the option of providing updated estimates to the QCA closer to the date of the final report. This is reasonable as most regulatory pricing decisions use market rates as close as possible (eg, a few months) to the start of the next regulatory period.

5 Historical Water Grid Manager cost of debt

- Seqwater requires historical WGM costs for FY15–FY17 and an estimate for FY18 to true-up the price path debt (Table 2). The estimates include QTC's administration fee and are expressed on an annual effective basis.
- The post-lengthening WGM cost of debt to apply in FY18 is 5.11 per cent (annual effective rate including QTC's administration fee).

TABLE 2: ANNUAL EFFECTIVE WGM PLL COST OF DEBT

| Financial year | Average cost (%) |
|----------------|------------------|
| 2014–15 | 5.71 |
| 2015–16 | 5.61 |
| 2016–17 | 5.44 |
| 2017–18 | 5.11 |

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