QUEENSLAND
TREASURY
CORPORATION

24 October 2012

Mr John Pierce
Chairman
Australian Energy Market Commission
PO Box A2449
SYDNEY SOUTH NSW 1235

Reference code: ERC0134

Dear Mr Pierce

The Queensland Treasury Corporation is pleased to provide comments on the savings and transitional arrangements proposed by the Australian Energy Market Commission (AEMC) and TransGrid.

Our comments relate to the process and timing for estimating the benchmark return on debt and the ability for service providers to align actual debt costs with the return on debt allowance in the presence of a transitional year and a compressed regulatory timetable.

If you require any further information please call Brian Carrick on (07) 3842 4716 or David Johnston on (07) 3842 4782.

Sincerely

Steven Tagg
Acting Chief Executive

Attach.

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QTC comments on proposed savings and transitional arrangements

REFERENCE CODE: ERC0134
OCTOBER 2012

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General comments

The transitional arrangements proposed by the AEMC and TransGrid may have implications for the way service providers manage interest rate risk. As a consequence, it is essential the transitional arrangements do not unintentionally produce return on debt allowances that cannot be replicated in practice. Such an outcome would be contrary to the principle of providing service providers with a reasonable opportunity to recover efficient financing costs.

It is equally important for the transitional arrangements to not require service providers to adopt inefficient risk management strategies to align actual debt costs with the return on debt allowance.

QTC considers that a single determination should be used to estimate the benchmark return on debt. To avoid creating additional interest rate risks, the averaging period used to estimate the return on debt should end just prior to the start of the transitional year or, alternatively, the transitional year could be used as an extended averaging period. This will allow service providers to enter into interest rate hedging transactions over the same time period used to estimate the benchmark return on debt.

Due to a significant increase in debt volumes and the possible transition to a new return on debt approach, some service providers will require an averaging period for the benchmark return on debt which is significantly longer than the current forty day maximum. It is therefore important for the transitional arrangements and compressed regulatory timetable to not prevent a service provider from seeking a longer averaging period as part of the framework and approach process. Using the transitional year as an extended averaging period is one way of achieving this outcome.

AEMC proposed transitional arrangements

The AEMC has proposed delaying the commencement date of the next full regulatory period for most service providers by one year. The proposed transitional arrangements allow the Australian Energy Regulator (AER) and the service provider to agree a term of less than five years for the next full regulatory period. This effectively results in a one-year transitional determination being followed by a shortened four-year regulatory determination.

Impact of the transitional determination

It is QTC's understanding that the transitional determination would require a weighted average cost of capital (WACC) to be fixed for one year with a new WACC being estimated just prior to the start of the delayed four-year regulatory period.

A two-determination process may create problems for some service providers when managing their interest rate risk exposure relative to the return on debt allowance. In particular, it may not be possible for service providers (especially those with large debt portfolios) to lock in a fixed base interest rate for one year and then fully re-hedge the rate just prior to the start of the delayed four-year regulatory period.

QTC considers that it is more appropriate for the benchmark return on debt to estimated as part of a single determination.

TransGrid proposed transitional arrangements

The TransGrid proposal involves a single determination which applies to all years of the five-year regulatory period. As the timing of the determination is delayed by one year, it is necessary for a 'placeholder' revenue to be agreed between the AER and the service provider for the transitional year. The placeholder revenue is based on an indicative WACC and forecasts for operating and capital expenditure, tax expense, depreciation and the opening regulated asset base.

The proposal includes a true-up to account for differences between the final determination and the estimates used to calculate the placeholder revenue. For example, the difference between the indicative and final WACC would be amortised on a present value neutral basis over the remaining four years. Under the current return on debt approach, this effectively results in the total revenues for the five-year regulatory period being based on the final WACC.

Possible increase in interest rate risk

It is unclear when the return on debt component of the final WACC is estimated under the TransGrid proposal. If the return on debt is estimated over a ten to forty day averaging period towards the end of the transitional year, the service provider may be exposed to additional interest rate risk.

To illustrate, if the indicative and final return on debt estimates were calculated using base interest rates of 4 per cent and 3 per cent respectively, the true-up calculation would reduce the revenues for the remaining four years to reflect the higher return on debt (ie, 4 per cent) used to determine the placeholder revenue. Under the current return on debt approach, this will result in the total revenues for the five-year regulatory period reflecting a base interest rate of 3 per cent. However, it would not have been possible for the service provider to lock in a 3 per cent base interest rate prior to the start of the transitional year for a five-year period.

As noted previously, it may not be possible for service providers with large debt portfolios to lock in a fixed base interest rate on existing borrowings for a one year period. Even if this was possible, the actual interest rate paid in during the transitional year is likely to differ from the interest rate used to perform the true-up calculation.

These risks can be avoided by choosing an appropriate start and end date for the averaging period used to estimate the benchmark return on debt component of the final WACC.

Timing and length of the averaging period

QTC considers that each service provider should be able to propose the timing and length of the averaging period used to estimate the benchmark return on debt. The details of the averaging period would be agreed between the AER and the service provider as part of the framework and approach process.

Timing of the averaging period

The additional interest rate risks that may unintentionally arise under the TransGrid proposal can be avoided if the return on debt component of the final WACC is estimated over an averaging period which ends just prior to the start of the transitional year, or if the transitional year is used as an extended averaging period.

Using the transitional year as an extended averaging period will allow some service providers to progressively hedge the base interest rate on existing borrowings at an average rate which is broadly consistent with the average base interest rate used in the final benchmark return on debt[1]. An indicative benchmark return on debt could still be estimated over a shorter time period prior to the start of the transitional year to determine the placeholder revenue.

Both approaches will result in a single averaging period for estimating the benchmark return on debt used to determine the total revenues for the five-year regulatory period. Importantly, service providers should be able to enter into interest rate hedging transactions over the same time period, thereby reducing the mismatch between actual debt costs and the return on debt allowance over the five-year regulatory period.

Length of the averaging period

The current maximum averaging period of forty days was determined by the AER as part of the 2008-09 WACC parameter review. Since this time the debt balance for some service providers has increased significantly. In addition, some service providers may be transitioning to a different return on debt approach such as a long-term trailing average of the total return on debt. This transition may require additional debt funding and interest rate hedging transactions to be undertaken prior to the start of the next regulatory period.

Providing a service provider with a reasonable opportunity to recover efficient financing costs is consistent with the Revenue and Pricing Principles (RPP). Satisfying this principle requires a service provider to be afforded sufficient time to enter into the hedging transactions required to align actual debt costs with the return on debt allowance. Without a longer averaging period some large service providers will be constrained in their ability to achieve an outcome that is consistent with the RPP.

Based on these considerations, it is QTC's view that some service providers will require an averaging period of at least *six months* to perform the necessary funding and interest rate hedging transactions. Provided the averaging period is forward-looking (ie, chosen without the

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1 Progressively hedging the base interest rate over a one year period may not be appropriate for service providers with a mostly floating rate interest rate exposure towards the end of the current regulatory period. In addition, debt covenants may require some service provider to maintain a minimum level of fixed rate hedging.

benefit of hindsight), there will be no opportunity for gaming by the service provider. A longer averaging period will also achieve a greater amount of smoothing in the benchmark return on debt, which protects consumers against short-term volatility in the return on debt parameters without imposing additional costs.