QUEENSLAND
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CORPORATION

4 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 (QTC) welcomes the opportunity to provide comments to the Australian Energy Market Commission (AEMC) on the draft rule determinations and associated guidance relating to the economic regulation of network service providers.

Our comments relate to the draft rules and guidance for the rate of return and in particular the return on debt. We have not commented on the draft rules or guidance for the treatment of operating and capital expenditure or the conduct of regulatory determinations.

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

Sincerely

Steven Tagg
Acting Chief Executive

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Submission to the Australian Energy Market Commission

Draft Rule Determination

Draft National Electricity Amendment (Economic Regulation of Network Service Providers) Rule 2012

Draft National Gas Amendment (Price and Revenue regulation of Gas services) Rule 2012

REFERENCE CODE: ERC0134
OCTOBER 2012

QUEENSLAND TREASURY CORPORATION

Summary of QTC's views

QTC's views on the rate of return and return on debt proposals are as follows:

Rate of return framework

- Requiring the regulator to consider a range of estimation methods, financial models, market data and other evidence has the potential to lead to improved rate of return estimates. However, additional requirements should be placed on the regulator in developing the rate of return guidelines to increase the likelihood of this potential being realised in practice.
- To promote transparent decision making the regulator should be required to assign quantitative weights to the financial models that it intends to use, and set out its reasoning behind how those weights have been determined. This will provide stakeholders with appropriate guidance as to how the allowed return on debt and return on equity will be determined and, equally importantly, how the regulator's approach may evolve in the future in response to changing market conditions.

Return on debt

- QTC supports most aspects of the proposed changes to the approach for estimating the allowed return on debt, and considers the changes to be an improvement on the current approach.
- QTC strongly supports the inclusion of trailing average-based approaches in the Rules. This will allow service providers with large debt portfolios to reduce the uncompensated risks created by the current return on debt approach without imposing additional costs on consumers. Consumers will also benefit from a more stable long-term return on debt allowance being reflected in regulated revenues/prices.

- For the proposed changes to be effective in achieving the AEMC's objectives it is essential that the choice of the return on debt approach (eg, the current approach, a trailing average or a combination of these two approaches) be at the discretion of the service provider. The regulator should focus on assessing a service provider's proposal against the factors listed in the Rules and the allowed rate of return objective.
- The AEMC's decision to make it clear that the regulator can consider return on debt proposals based on three broad approaches is a prudent and non-prescriptive way of allowing the specific circumstances of each service provider to be taken into account. For this approach to be effective it is important that the service provider's proposal be afforded primacy in the regulator's assessment of the appropriate return on debt approach and the allowed return on debt.
- QTC considers that it would be appropriate for the AEMC to confirm the significance of a service provider's return on debt proposal in the same way as the service provider's operating and capital expenditure proposal.
- The regulator should be required to accept a service provider's return on debt proposal if it is consistent with the factors listed in the Rules and the allowed rate of return objective. This will ensure that service providers can adopt and maintain prudent debt management strategies without facing the risk that the regulator can propose (or impose) an alternative approach that is inconsistent with the chosen debt management strategy.
- QTC notes that the draft Rules provide a broad discretion to the regulator in specifying the characteristics of the debt benchmark, and suggests this should be balanced by requiring the regulator to have regard to the characteristics of efficient debt financing and risk management strategies for highly geared infrastructure service providers.
- In QTC's view, the Rules should require the regulator to demonstrate that its preferred debt benchmark does not constrain the ability of service providers to adopt efficient debt financing and risk management strategies. Regulatory-imposed constraints on the use of efficient funding strategies are contrary to the National Electricity Objective (NEO), the National Gas Objective (NGO) and the Revenue and Pricing Principles (RPP).
- QTC supports the AEMC's decision to not adopt the Energy Users Rule Change Committee (EURCC) proposal for different return on debt methodologies to apply to privately-owned and state-owned service providers.

Rate of return framework

Return on debt terminology

For the purpose of this submission QTC has interpreted the *return on debt approach* to mean the three approaches listed in the draft Rules:

- the prevailing cost of funds approach
- an historical trailing average approach, or
- some combination of these two approaches.

The *return on debt methodology* is assumed to refer to the estimation techniques, models and data sources that may be used by the regulator to estimate the value of the debt benchmark (ie, the benchmark corporate cost of debt based on the characteristics specified by the regulator) at a given point in time.

The *allowed return on debt* is assumed to be the result from applying the return on debt approach to the value of the debt benchmark produced by the return on debt methodologies.

Estimating a rate of return for a benchmark efficient service provider

QTC agrees with the AEMC's approach for determining a rate of return for a benchmark efficient service provider:

> *'The Commission considers that the rate of return framework should provide a rate of return for a benchmark efficient service provider, and that, in developing the characteristics of a benchmark efficient service provider, the regulator considers the risk profile of the service provider to determine whether the benchmark chosen is appropriate. Therefore, the attribute of focussing on a benchmark efficient service provider can incorporate the consideration of the specific risks of a service provider operating in a regulated environment.'* [1]

The AEMC's approach is an improvement on the current approach as it acknowledges that compensation for efficient financing costs can still be provided within an incentive-based framework if some of the specific risks faced by a service provider are taken into account.

Allowed rate of return objective

The allowed rate of return objective in the draft Chapter 6 requires the regulator to consider the nature and degree of risks applicable to the service provider whose rate of return is being determined.

Presumably the nature and details of the risks will be considered during the rate of return guideline consultation. However, QTC considers it important that any differentiation in risks which may arise from ownership status or implied support from a parent company should be explicitly excluded from consideration in determining the allowed rate of return.

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[1] AEMC, Draft rule determinations, 23 August 2012, p. 45.

Interrelationships between parameter values

QTC supports the requirement for the regulator to consider interrelationships between parameters that are relevant to the return on debt and return on equity.

As the debt and equity providers to a firm have claims on the cash flows produced by the same assets, the expected excess returns required by each group will be affected by the same systematic risks. Furthermore, given the senior ranking of the debt providers' claim, the margin between the debt risk premium and the equity risk premium serves as a reasonableness check for the overall rate of return estimate. Given this clear relationship, QTC would support the Rules requiring the regulator to demonstrate that the preferred methodologies to estimating the return on equity and debt are expected to result in a return on equity estimate that is higher than the return on debt estimate.

Methodologies driven by principles and reflecting current best practice

Requiring the regulator to consider a range of estimation methods, financial models, market data and other evidence has the potential to lead to improved estimates of the return on debt and return on equity. However further guidance should be provided in the Rules to ensure this potential is realised in practice.

The draft Rules provide the regulator with a broad discretion to determine the allowed rate of return. In order to provide confidence to investors that the discretion will be exercised in accordance with the NEO, NGO and RPP, the Rules should provide for a transparent approach which provides detailed reasoning behind the choices which have been made by the regulator.

Recent decisions suggest that the weighting applied to different models, and the process for assigning weights, has a significant impact on rate of return outcomes. While the current electricity rules do not allow the regulator to choose between models, there are examples where the regulator can choose between different data sources and estimation techniques. The approach used by regulators to determine the market risk premium (MRP) is a useful and timely example.

In recent decisions handed down by the Australian Energy Regulator (AER)[2] and the Economic Regulation Authority (ERA)[3], consideration was given to MRP estimates implied by the dividend growth model (DGM). Both regulators effectively assigned a zero weight to the DGM-based estimates in the final MRP estimate used to determine the allowed return on equity. These decisions appear to have been based largely on the weaknesses of the DGM.

Without a comprehensive analysis it is inappropriate to conclude that the weaknesses of the DGM are so significant compared to the alternative models as to justify a zero weight in the derivation of the final MRP estimate. A zero weight is equivalent to concluding that the DGM is of no use in determining the best estimate of the return on equity.

The appropriate weight that should be assigned to a model cannot be determined by a stand-alone assessment of its weaknesses. It is only when the strengths and weaknesses of a range of

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2 AER, *Access arrangement final decision, Roma to Brisbane Pipeline 2012-13 to 2016-17*, August 2012.

3 ERA, *Final Decision on Proposed Revisions to the Access Arrangement for the Western Power Network*, 5 September 2012.

models are jointly considered that a sensible set of weights can be determined. Most importantly, each model should be assessed against a common standard.

The AEMC has correctly concluded that 'weaknesses in a model do not necessarily invalidate the usefulness of the model' so there may be an expectation that the regulator will no longer make decisions in this way[4]. However, there are no requirements in the Rules that will prevent this type of decision making from being repeated under the new rate of return framework.

Discretion and regulatory certainty

The AEMC has concluded that the overriding consideration for the rate of return framework is achieving the best estimate of the rate of return, and that regulatory certainty is a secondary consideration[5]. It is QTC's understanding that the AEMC's use of the term 'best estimate' relates to the estimate which best promotes the NEO, NGO and RPP rather than the most accurate estimate from a purely statistical perspective.

QTC's previous submissions have emphasised the impact of regulatory certainty on investor perceptions about the risk of making long-term investments in the sector, which is in turn a significant driver of the required rate of return[6]. There is a clear link between certainty and predictability in the regulatory regime and the prices which will be paid by consumers in the long run.

As the AEMC has concluded that its preferred approach is to explicitly require the regulator to consider a wide range of estimation methods, financial models, market data and other evidence, this, in QTC's view, should be accompanied by measures which address the concerns of investors. It is in the interest of consumers that the rule changes improve the regulator's ability to produce rate of return estimates which best promote the NEO and NGO. However, it is important that investors are provided with adequate confidence that regulatory outcomes will be the result of a transparent and robust decision-making process.

QTC considers that this balance can be achieved by placing additional requirements on the regulator when developing the rate of return guidelines to ensure that all methods and estimates are objectively and transparently evaluated based on their strengths and weaknesses *relative* to the alternatives. This should increase the likelihood of the regulator's increased discretion leading to improved rate of return estimates and provide stakeholders with greater certainty as to how the allowed return on debt and return on equity will be determined.

Rate of return guidelines

QTC supports a thorough consultative approach for the development of the rate of return guidelines and agrees that the guidelines should provide a meaningful signal as to how the allowed rate of return will be estimated by the regulator.

In developing the rate of return guidelines the AEMC expects the regulator to perform several tasks including[7]:

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[4] AEMC Draft rule determinations, p. 48.
[5] Ibid, p. 51.
[6] QTC, AEMC submission on the proposed changes to the National Electricity Rules, 7 December 2011, pp. 24-25.
[7] AEMC Draft rule determinations, p. 60.

- detailing the financial models that it would take into account in its decision, and why it has chosen those models rather than other models, and
- providing guidance on how it would use such models and information in reaching its decision, including matters such as the relative weight (although not necessarily in a quantitative way) it would expect to place on various model estimates.

QTC considers that the first point should be strengthened by a requirement in the Rules for the regulator to perform a detailed analysis of the strengths and weaknesses of a range of estimation methods, financial models and market data, including those it proposes to use[8]. The results from the analysis should be included in the draft rate of return guidelines so they can be assessed and scrutinised by stakeholders.

Regarding the second point, the weights that the regulator intends to apply should be quantitative and proportional to the relative strengths and weaknesses of each method compared to the alternatives. Although market conditions have changed continually since the onset of the Global Financial Crisis, finance theory and the suitability of different models have not changed to the same extent. In this context, it should be reasonable to require the regulator to assign quantitative weights at each determination or access arrangement taking into account its own prior views on those models, and to justify changes to the relative weights that are applied. This approach recognises that:

- decisions as to the relative merits of various models should be made taking into account the fundamental strengths and weaknesses over time, rather than simply the outcomes of each model at any point in time
- the relative strengths and weaknesses of the various models to be considered are unlikely to change significantly over relatively short periods of time, and
- even if such changes were to occur, it would not be possible for the regulator to consistently determine the size and timing of the changes to accurately 'switch' between models.

This approach will provide stakeholders with confidence as to how the allowed rate of return proposals will be considered by the regulator in future determinations and increase investor confidence in the predictability of the new approach. Quantitative weights are also necessary for service providers and consumers to be able to 'make a reasonably good estimate of the rate of return that would be determined by the regulator if the guidelines were applied.' [9]

Balancing increased flexibility with increased accountability and transparency

These additional requirements are not intended to impose constraints on the estimation methods, financial models, and market data that can be considered by the regulator to determine the allowed rate of return. The non-binding nature of the guidelines will still allow the regulator or service provider to propose different weights at the time of a determination or access arrangement, provided there are valid reasons and supporting evidence for making a change.

[8] The AER has expected gas businesses to perform the same analysis if they choose to propose an alternative approach to the Sharpe-Lintner CAPM to estimate the allowed return on equity.

[9] AEMC Draft rule determinations, p. 60.

The additional requirements will encourage transparent decision making and increase the accountability on the regulator to justify its decisions when choosing from an expanded range of imperfect estimation techniques and financial models.

Recent decisions made under the current Rules demonstrate that a requirement to 'have regard' to an estimate or model does not automatically lead to a transparent and well-supported process of assigning weights based on the strengths and weaknesses of the estimate or model relative to the alternatives. The requirements outlined in this section should increase the likelihood of improved rate of return estimates being made in an environment where the discretion available to the regulator has been significantly increased.

QTC believes the Rules should require the regulator to perform and report the results of a detailed analysis of the strengths and weaknesses of a range of estimation methods, financial models and market data, including those it proposes to use.

The draft and final version of the rate of return guidelines should include the quantitative weights that the regulator intends to apply to each methodology for estimating the return on equity, and the estimate of the return on equity produced by each methodology assuming a determination or access arrangement were made at that time. The regulator's point estimate of the weighted average return on equity should also be provided.

The draft and final version of the rate of return guidelines should include the quantitative weights that the regulator intends to apply to each methodology for estimating the value of the debt benchmark, and the estimate of the value of the debt benchmark produced by each methodology assuming a determination or access arrangement were made at that time. The regulator's point estimate of the weighted average value of the debt benchmark should also be provided.

Efficient debt costs

The AEMC has emphasised the importance of setting rate of return allowances based on efficient financing costs. In relation to the return on debt, efficient costs can be viewed as the outcome from implementing efficient funding and risk management strategies. These strategies determine the long-term average cost of debt and how the cost of debt varies over time.

It follows that an appropriate return on debt allowance cannot be determined without a clear understanding of what these efficient strategies are for infrastructure service providers. In QTC's view, efficient debt costs are the costs that would be expected to be incurred by a firm that prudently structures and manages its borrowings and interest rate exposure based on a range of market-based factors and risks, such as the need to keep refinancing risk at an acceptable level. This view is consistent with the AEMC's conclusion on how the return on debt allowance should be determined:

> *'The Commission considers that the long-term interests of consumers are best served by ensuring that the methodology used to estimate the return on debt reflects, to the extent possible, the efficient financing and risk management practices that might be expected in the absence of regulation.'* [10]

[10] AEMC Draft rule determinations, p. 73. We note the AEMC's use of the word 'methodology' in the context of this quote relates to the approach used to estimate the return on debt allowance (eg, a trailing average or the current approach) rather than the methodology used to estimate the value of the debt benchmark.

QTC agrees that efficient financing and risk management strategies (and as a consequence, efficient debt costs) are not the product of regulatory design or constraint.

Given the relationship between efficient debt strategies and efficient debt costs, QTC believes the rate of return guidelines should describe the main characteristics of efficient debt funding and risk management strategies for infrastructure service providers. The regulator should be required to have regard to these characteristics when assessing a service provider's return on debt proposal, and when determining the characteristics of the debt benchmark.

Proposed timeframes for responding to AER publications

The draft Rules currently require a period of not less than thirty days for stakeholders to respond to the regulator's consultation paper and draft rate of return guidelines. Given the breadth of issues that are likely to be raised in the development of the guidelines, it is important for all stakeholders to have sufficient time to assess the regulator's proposals and formulate a considered and informed response. QTC considers that a period of not less than sixty days would be more appropriate.

Return on debt

This section should be read in conjunction with the return on debt terminology outlined on page 3 of this submission.

Return on debt approaches

The AEMC has listed three broad approaches in section 6.5.2 (g) of the draft Rules that can be used to determine the allowed return on debt:

- the prevailing cost of funds approach
- an historical trailing average approach, or
- some combination of these two approaches.

QTC strongly supports the inclusion of trailing average approaches in the draft Rules and agrees with the AEMC's view that the best approach for estimating the return on debt may not be the same for all service providers.[11]

Providing a service provider with a reasonable opportunity to recover efficient financing costs is consistent with the RPP. Satisfying this principle requires a service provider to be afforded a reasonable opportunity to align its actual debt costs with the return on debt allowance. The three broad approaches should provide service providers with a reasonable opportunity, so long as the regulator exercises its discretion in a manner consistent with the RPP.

Factors the regulator must have regard to when considering the return on debt approach

The AEMC has listed four factors in section 6.5.2 (h) of the draft Rules that the regulator must have regard to when considering the approach to estimating the return on debt, and has provided guidance on how these factors are to be considered by the regulator:

1. the likelihood of differences between the cost of servicing debt of a benchmark efficient service provider and the estimated return on debt.
2. the impact on consumers, including the impact on the return on equity.
3. the incentive effects of inefficiently delaying or bringing forward capex.
4. the impact from changing the methodology across regulatory periods.

QTC agrees with draft clauses (1) and (3) and broadly agrees with draft clause (4) although the associated guidance could be amended to better align with SFG Consulting's conclusions on the importance of transitional arrangements[12].

QTC considers draft clause (2) to be unnecessary. There should be no need to make explicit adjustments to the allowed return on equity based on the return on debt approach that is required by a service provider to align its actual debt costs with the return on debt allowance.

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11 AEMC Draft rule determinations, p. 63.

12 SFG Consulting, *Rule change proposals relating to the debt component of the regulated rate of return*, 21 August 2012, pp. 45-48.

In QTC's view, draft clauses (1), (3) and (4) could be treated as the criteria that the regulator must use in conjunction with the allowed rate of return objective to assess a service provider's return on debt proposal. This approach treats the service provider's return on debt proposal as the appropriate starting point for determining the return on debt allowance.

Impact on consumers, including the impact on the return on equity

The AEMC's guidance suggests that a reduction in the required return on equity may be appropriate if a trailing average approach can reduce risks for an efficiently financed service provider[13].

In QTC's view the allowed return on equity should reflect the required return for a benchmark efficient service provider that is able to align its actual cost of debt with the return on debt allowance. If the return on equity is estimated on this basis, and provided each service provider can choose the return on debt approach that is most applicable to its circumstances, there should be no need to make explicit adjustments to the allowed return on equity.

The three return on debt approaches listed in the draft Rules should allow all service providers, regardless of size or other characteristics, to achieve a similar level of matching between actual and benchmark debt costs. This supports the use of common allowed return on equity parameters irrespective of the return on debt approach used by a particular service provider.

> QTC considers draft clause 6.5.2 (h)(2) to be unnecessary. Provided the allowed return on equity is estimated under an appropriate framework, there should be no need to make an explicit adjustment based on the return on debt approach that a service provider uses to align its actual debt costs with the return on debt allowance.

Impact from changing the methodology across regulatory periods

Draft clause (4) could be simplified by requiring the regulator to consider the extent to which a return on debt proposal contains detailed transitional arrangements (if applicable). The most important transitional arrangements are those required when the new return on debt approach is first adopted. Potential transitional arrangements that may be required if subsequent changes are made to the return on debt approach could also be considered.

Ability of the regulator to determine the best return on debt approach

The AEMC considers that the regulator is in the best position to determine the best approach for estimating the return on debt[14]. Although QTC understands this to mean that a single approach should not be prescribed by the AEMC in the Rules, in practice, it is the service provider that is in the best position to determine the approach that is most applicable to its circumstances.

Service providers are experienced in issuing debt, managing refinancing risk, interacting with existing and potential lenders, and implementing interest rate risk management strategies. Based on this experience, it is reasonable to assume that a service provider's return on debt

[13] AEMC Draft rule determinations, p. 92.
[14] Ibid, p. 63.

proposal will reflect the specific funding and risk management strategies that are available to that service provider. Each service provider will also have a better understanding of the transitional arrangements that may be required based on the hedging transactions that are already in place. Based on these considerations, it is appropriate for the service provider's proposal to be afforded primacy in the regulator's assessment of the appropriate return on debt approach and the allowed return on debt.

Significance of a service provider's return on debt proposal

QTC is strongly of the view that a service provider's return on debt proposal is the most appropriate starting point for determining the return on debt allowance. This is consistent with the AEMC's reasons for confirming the significance of a service provider's operating and capital expenditure proposal:

> *'In clarifying the AER's powers the Commission has confirmed its overall approach to capital expenditure and operating expenditure allowances. The NSP's proposal is necessarily the starting point for the AER to determine a capital expenditure or operating expenditure allowance,* **as the NSP has the most experience in how its network should be run.***'* [15] *[emphasis added]*

Treating a service provider's return on debt proposal in the same way will allow the regulator to focus on assessing the proposal against the factors listed in the Rules and the allowed rate of return objective. This will not prevent the regulator from recommending changes to the proposal if it is demonstrated to be deficient.

> QTC considers that it would be appropriate for the AEMC to confirm the significance of a service provider's return on debt proposal as the starting point for the regulator to determine the return on debt allowance.
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> The Rules should require the regulator to accept a service provider's return on debt proposal if it is consistent with the factors listed in the Rules and the allowed rate of return objective.

Requirement for the regulator to develop detailed return on debt approaches

The three approaches listed in the draft Rules are sufficiently broad to allow for more specific proposals to be developed by service providers and included in their regulatory proposals.

As the service provider is in the best position to determine the approach that is most applicable to its circumstances, it is unclear as to why the regulator would be expected to develop its own detailed return on debt approaches:

15 AEMC Draft rule determinations, p. vi.

'The Commission intends that the regulator (and the service provider in its regulatory proposal or access arrangement proposal) have the discretion to propose an approach that it considers best meets the overall rate of return objective. This discretion for the regulator includes the detail of any approach, such as the period over which a prevailing cost of debt is observed, the length of any historical averaging period, and the form of measurement of the observed financing costs.' [16]

Given that a large number of specific approaches could be developed based on the three broad approaches listed in the draft Rules, it would be impractical for the regulator to attempt to develop multiple detailed return on debt approaches as part of the rate of return guidelines. However, the regulator may be best placed to develop the methodology for determining the annual adjustment to the allowed revenues in the post-tax revenue model (PTRM) based on changes in the allowed return on debt during the regulatory control period.

In QTC's view, it would be more appropriate for the regulator to focus on assessing service providers' return on debt proposals and developing methodologies for estimating the value of the debt benchmark. If a sufficient level of commonality in the return on debt proposals emerges over time, these details could be included in subsequent reviews of the rate of return guidelines. Alternatively, specific return on debt proposals could be included in the guidelines as case studies or examples to help inform the development of future proposals. In the meantime, the regulator could provide guidance on the matters that it expects to see addressed in a service provider's return on debt proposal.

Methodologies for estimating the value of the debt benchmark

The rate of return framework requires the regulator to develop and assess methodologies for estimating the value of the debt benchmark (ie, the benchmark corporate cost of debt at a point in time and over time). Developing these methodologies will require consideration of range of potential data sources and estimation techniques such as the fitting of sophisticated yield curve models to observable corporate debt yields.

Assessing the potential methodologies for estimating the value of the debt benchmark will be an important part of the development of the rate of return guidelines. It is QTC's view that the return on debt methodologies considered by the regulator should be subject to the same detailed analysis of the strengths and weaknesses as the estimation techniques and financial models used to estimate the return on equity. Further, it is assumed that related matters such as debt-raising costs and the costs of pre-issuing new debt to refinance maturing debt will be considered in the development of the rate of return guidelines.

To promote transparency in the regulator's decision-making process, the rate of return guidelines should detail the reasoning behind the regulator's choice of weights to apply to the different methodologies for estimating the value of the debt benchmark.

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[16] AEMC Draft rule determinations, pp. 90-91.

QTC considers that it is more appropriate for the regulator to focus on assessing a service provider's return on debt proposal and developing methodologies for estimating the value of the debt benchmark, rather than developing its own detailed return on debt approaches.

The draft and final version of the rate of return guidelines should include the quantitative weights that the regulator intends to apply to each methodology for estimating the value of the debt benchmark, and the estimate of the value of the debt benchmark produced by each methodology assuming a determination or access arrangement were made at that time. The regulator's point estimate of the weighted average value of the debt benchmark should also be provided.

Specification of the debt benchmark

QTC notes that the draft Rules provide a broad discretion to the regulator in specifying the characteristics of the debt benchmark, and suggests this should be balanced by requiring the regulator to have regard to the characteristics of efficient debt financing and risk management strategies for highly geared infrastructure service providers.[17]

Currently, beyond the requirement for the return on debt to be consistent with the allowed rate of return objective, there is no guidance on the factors that must be considered by the regulator when determining the characteristics of the debt benchmark. This creates a risk that the regulator may choose a benchmark with characteristics that constrain the ability for service providers to adopt efficient debt financing and risk management strategies.

Although the AEMC did not reach a view on the appropriateness of current characteristics used by regulators to define the debt benchmark, a clear view was reached on how the return on debt allowance should be determined:

> *'The Commission considers that the long-term interests of consumers are best served by ensuring that the methodology used to estimate the return on debt reflects, to the extent possible, the efficient financing and risk management practices that might be expected in the absence of regulation.'* [18]

We have referenced this quote again because it also applies to the characteristics of the debt benchmark, and, in particular, the debt benchmark tenor. This conclusion is consistent with previous advice provided to the AEMC by SFG Consulting:

> *'Yet there seems to be no reason why the term of the regulatory period, which represents a trade-off between administrative efficiency and timeliness of reviews, would bear any relationship to the prices which would prevail in a competitive market.'* [19]

These quotes indicate that the return on debt approach and the characteristics of the debt benchmark should not be based on factors that are unique to the regulatory framework, such as the term of the regulatory period. Estimating the return on debt in the absence of regulatory constraints:

[17] The characteristics of the debt benchmark include parameters such as the tenor, credit rating, and the forms of debt finance that may be used by a benchmark efficient service provider.

[18] AEMC Draft rule determinations, p. 73.

[19] SFG Consulting, *Preliminary analysis of rule change proposals, Report for AEMC*, 27 February 2012, para. 180, p. 43.

- is consistent with the broader regulatory objective of attempting to replicate competitive market outcomes, and
- acknowledges that regulated service providers must raise capital in competition with other long-lived assets including property and infrastructure classes, which provide appropriate long-term returns for long-term investment.

The relationship between the debt benchmark tenor and managing refinancing risk

The prudent management of refinancing risk for a highly geared capital intensive business with stable revenues requires maintaining a diversified debt maturity profile and having ongoing access to long-term debt. The efficient cost of debt for this type of business will be based on a long-term fixed rate corporate cost of debt, and the presence of economic regulation should not change this outcome.

As market conditions and investor preferences will occasionally limit the availability of long-term debt and constrain the choice of debt tenor, it is essential the regulator not impose constraints that may reduce the ability of regulated service providers to manage refinancing risk and adopt efficient debt management practices. Regulatory-imposed constraints on the use of efficient financing strategies are contrary to the NEO, NGO and RPP.

QTC considers that the Rules should require the regulator to demonstrate that the preferred debt benchmark characteristics will not constrain the ability of service providers to adopt efficient debt financing and risk management strategies.