

7 December 2011

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

Reference code: ERC0134

Dear Mr Pierce

Queensland Treasury Corporation welcomes the opportunity to provide comments to the Australian Energy Market Commission on the proposed changes to the National Electricity Rules made by the Energy Users Rule Change Committee and the Australian Energy Regulator.

Our comments relate to the proposals that affect the weighted average cost of capital, the debt risk premium and the regulated cost of debt for government and privately-owned Network Service Providers. We have not commented on other proposals that relate to the treatment of operating and capital expenditure or the conduct of regulatory determinations.

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

Sincerely



Philip Noble
Chief Executive

Submission to the Australian Energy Market Commission



PROPOSED CHANGES TO THE NATIONAL ELECTRICITY RULES MADE BY
THE ENERGY USERS RULE CHANGE COMMITTEE AND THE AUSTRALIAN
ENERGY REGULATOR

REFERENCE CODE: ERC0134

DECEMBER 2011

Summary of QTC's views

In the context of increasing capital expenditure on electricity networks and rising retail electricity prices, it is critical that stakeholders have confidence in the means used to calculate regulated revenue allowances.

This is particularly important for the return on capital component, where the weighted average cost of capital (WACC) parameters are determined by reference to complex corporate finance theory and estimates may be subject to uncertainty and estimation error.

The significant funding requirement to refinance existing debt and fund capital expenditure requires that investors and financiers have confidence in the stability and predictability of the revenue framework, especially given the ongoing market turmoil that started in 2008 and has recently re-intensified.

The Australian Energy Regulator (AER) and Energy Users Rule Change Committee (EURCC) rule change proposals have identified a number of issues relating to the estimation of the debt risk premium (DRP).

Queensland Treasury Corporation (QTC) does not agree with their conclusion that the current framework leads to systematic over-compensation for the cost of corporate debt.

QTC considers the National Electricity Rules' (NER) definition of DRP is too narrow, and that the AER has also taken a narrow interpretation of clause 6.5.2(e). In QTC's view, the combination of these two factors has led to the AER relying on a very limited range of data, and raising concerns that the DRP is not cost reflective.

QTC considers that, when a broader analysis of available data is undertaken, there is evidence that DRPs are not inconsistent with actual corporate debt costs, particularly when refinancing risks are taken into consideration.

QTC is concerned that the AER's proposal to repeal the existing definition and replace it with a broad regulatory discretion could increase uncertainty for Network Service Providers (NSP) and their debt and equity providers, potentially making it more difficult to raise funds in increasingly risk-adverse capital markets.

In contrast, QTC believes the incremental change suggested by the EURCC may provide an approach to addressing the data limitation issues raised in both submissions, subject to ensuring that appropriate benchmarks are specified, such as a ten-year tenor.

QTC's specific views in relation to the proposed rule changes by the EURCC and the AER are as follows:

- QTC considers that there are sound reasons for continuing to apply the same revenue and pricing principles to government and privately-owned NSPs. The risks of investing equity and debt in an NSP are the same irrelevant of whether the investment is made by government or the private sector. The EURCC has not made a compelling case to depart from National Competition Policy and has overlooked that NSPs pay a competitive neutrality fee to deal with the differential in the cost of debt.
- The EURCC has incorrectly concluded that Queensland Government-owned NSPs are not responsible for managing their debt (albeit that they are compelled to source the debt through QTC) and, therefore, do not respond to regulatory incentives.
- The EURCC's claim that a ten-year cost of debt over-compensates NSPs that have recently raised shorter-term debt does not account for the higher systematic risk borne by equity providers due to increased refinancing risk when NSPs are unable to raise longer-term funding.
- The regulated cost of debt for all NSPs should continue to be based on a ten-year risk-free interest rate and DRP. The increased issuance of shorter-term debt since 2008 is due to market conditions, rather than a change in the benchmark (or optimal) funding practices of NSPs.
- Using a longer-term moving average to calculate the regulated cost of debt may produce benefits for energy users and NSPs. The current approach significantly complicates the management of interest rate risk for NSPs, and exposes users to interest rate and DRP volatility at the time of price resets.
- QTC supports further analysis of whether the current definition of the cost of debt and the DRP allows consideration of a sufficient range of data sources, and whether the issue can be resolved through incremental changes as opposed to the AER's proposal to completely remove the definition from the NER. In this regard, QTC notes it is impossible to properly assess the AER's proposal without knowing the details of its proposed approach to calculating the corporate cost of debt. However, there are some indications in its submission that suggest that the AER is contemplating an approach that could vary significantly between WACC reviews and, therefore, substantially increase investor uncertainty.
- The rule change proposals need to be assessed having regard to the stability and certainty that is provided under the current cost of debt calculation and has supported the ability of NSPs to access capital markets during a period of significant global risk aversion.

Current financial markets conditions

The significant global economic uncertainties arising from the Eurozone crisis and US fiscal challenges have led to high levels of financial market volatility and increased risk aversion by financial intermediaries and investors. As a consequence, most global funding markets for term debt have now almost completely closed for all but the most liquid of sovereign issuers, such as the United States. With bond spreads rising rapidly there is limited buy-side liquidity in the market and risk tolerance among financial intermediaries is close to zero, leading to a material increase in transaction costs.

State government bond yields have widened considerably relative to Commonwealth Government bond yields on low volumes as continued headline risk emerges from Europe and banks liquidate inventory. These spread moves have been exacerbated by the lack of market liquidity and are now around the same level as the wide spreads experienced during the 2008-09 Global Financial Crisis.

Presently, the bond market is not conducive to any sizable semi-government primary issuance of term debt, primarily due to a high degree of volatility in yields and credit spreads. Although QTC has, in the past couple of months, been able to place some bonds with investors on a 'reverse enquiry' basis, this demand has been limited and inconsistent.

Short-term funding, via commercial paper markets, remains well supported; however, this is not a viable ongoing long-term funding source, given the higher level of refinancing risk. Domestic bank balance sheets continue to maintain a natural demand for semi-government bonds under the new liquidity regulations, but appear to be in no hurry to invest in the current climate with yield spreads trending wider.

The Australian corporate bond market has not been immune from sovereign debt concerns emanating from the Eurozone. A considerable amount of the narrowing in credit spreads witnessed in October has subsequently been unwound. With few concrete solutions to the debt burdens plaguing a number of European nations, liquidity in the domestic credit market has been scarce, and financial intermediaries' reduced risk appetite have resulted in spreads moving wider. The liquidity injection provided by the coordinated actions of six major central banks at the end of November, which cut the interest rate charged for US dollar swap arrangements, have to some extent eased the strains placed on financial markets.

Until such time as there is a credible solution to the European sovereign debt crisis, it is likely that credit spreads in the domestic market will remain elevated.

Rating agencies comments on NSPs

A consistent theme, in the rating agencies reports reviewed by QTC, is the value placed on the support provided by the stable regulatory regime to allow NSPs to raise capital to fund refinancing and capital expenditure. A number of rating reports commented on the significant

efforts undertaken by NSPs to reduce gearing in light of the global financial crisis and the demise of monoline insurers, which had previously facilitated the issue of credit-wrapped bonds for utilities at competitive yields.

In its *2011 Outlook: Australian Power and Utilities* issued in February this year, Fitch Ratings stated that:

Regulatory Determinations Support Credit: Fitch does not anticipate that the network businesses will encounter difficulties in refinancing, barring capital market disruptions or unforeseen operating factors. Many of the regulated networks benefit from recent favourable determinations issued by the AER.’¹

In May this year, Standard & Poor’s provided the following comment on the regulated sector:

In our view recent regulatory outcomes support the credit quality of regulated network businesses by Standard and Poor’s... [The South Australian and Queensland gas distribution] draft outcome, coupled with the final decisions last year for the five Victorian electricity distribution network providers (cover the period January 2011 to December 2015), is consistent with our view of a supportive regulatory system that is on the whole predictable, transparent and fair. In our opinion, the effective cash flow stability and level of allowed returns should help companies source additional debt funding for significant capital-expenditure programs.’²

Similarly, in a recent report, Moody’s Investors Service noted that regulated networks had been successful in managing their balance sheets to reduce leverage and diversify funding sources including accessing global capital markets. Moody’s observed that:

Having taken measures to strengthen their respective balance sheet position during the last two years, issuers in the sector are also expected to have greater capacity to manage the foreseeable increase in credit margins and increased volatilities in the capital market...

‘Given the continued volatilities in the capital market, it is important for issuers to remain vigilant on refinancing requirements to avoid being caught in sudden shifts in availability or pricing...’

The potential for increased regulatory uncertainty has been noted by both Moody’s and Standard & Poor’s. In a statement titled ‘Australian Energy Regulator’s Proposed Rule Changes Could Raise Credit Risks’ (issued 6 October 2011), Standard & Poor’s stated:

‘The potentially higher regulatory risks, in our view, could make it challenging for the network sector to attract capital on favourable terms, making it tougher for companies to maintain their financial profiles.’

Standard & Poor’s also noted that financial market conditions have impacted on the choice of debt funding for NSPs:

¹ Fitch Ratings ‘2011 Outlook: Australian Power and Utilities’, February 2011 page 3.

² Standard & Poor’s ‘Industry Report Card: For Australian Utilities, The Spotlight Turns to Asset Sales and Regulatory Outcomes, As Refinance Risks Moderate’, 26 May 2011.

‘Over the past six months, there has been some reluctance to refinance or secure debt funding from debt capital markets due to increased market volatility pushing financing costs higher. As a result, some issuers in the sector have opted for bank debt financing.’³

QTC’s discussions on this issue with the banks on its Fixed Interest Distribution Group (FIDG) confirm that the ability of NSPs to raise capital is supported by market perceptions of a stable regulatory regime that allows NSPs to recover their funding costs. In QTC’s view, it is important to consider the potential impacts of proposed rule changes on the actual cost of capital for NSPs, particularly given the recent deterioration in market conditions.

³ Standard & Poor’s ‘Industry Report Card: Australian Utilities are on a Firm Footing, But Confronting Regulatory Reviews, 21 November 2011, page 7.

Specific information requested by the AEMC

The AEMC has requested comments from central financing authorities on how debt is raised on behalf of government-owned NSPs and on how debt costs are levied on to the NSPs.

Comments have also been sought on the appropriateness of the debt benchmarks proposed by the EURCC⁴.

The role of QTC

QTC is the Queensland Government's central financing authority and corporate treasury services provider, with responsibility for:

- sourcing and managing the debt funding to finance Queensland's infrastructure requirements in the most cost-effective manner, and
- providing financial and risk management advice and services to the Queensland Government and Queensland's public sector bodies (QTC's clients).

QTC is the largest Australian semi-government issuer of Australian dollar-denominated bonds in both the domestic and offshore markets.

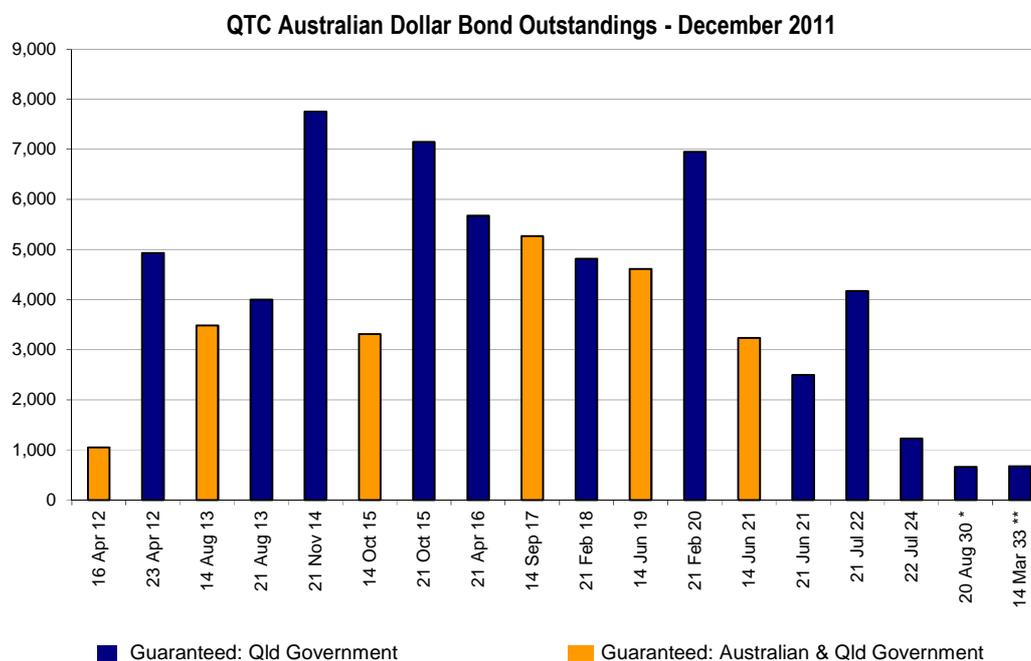
How the debt is raised

QTC borrows funds in the domestic and international financial markets by issuing a variety of debt instruments. The majority of the funding is raised through QTC's benchmark fixed-rate bond lines. Foreign currency bonds may also be issued on a fully swapped basis back into Australian dollars.

Shorter-term funding is raised by issuing discount securities and combining interest rate swaps with fixed rate bonds to create synthetic floating rate notes.

Total State borrowings are spread across multiple bond lines with a wide range of maturity dates as displayed in the following graph:

⁴ Our comments relate to the current debt issuance and management practices within the Queensland public sector. These practices may differ from those used by the other central financing authorities.



* Non-benchmark bond line

** Non-benchmark capital indexed bond

Approximately 70 per cent of QTC's benchmark bonds are guaranteed by the State Government, with the remaining benchmark bonds carrying both State and Commonwealth government guarantees. All on-lendings made by QTC to its clients (including the NSPs) are priced off the higher-yielding State Government guaranteed yield curve.

Primary debt issuance is usually performed prior to the borrowing and refinancing requirements of our clients. Newly issued debt is warehoused in QTC's surplus funding pool where the interest rate risk is hedged by purchasing fixed rate assets and interest rate futures contracts. QTC bonds and hedge assets remain in the surplus funding pool until required by a client.

How the debt is managed

The borrowings for all Queensland Government-owned corporations are managed within individual debt portfolios called Client Specific Pools (CSP). A CSP is a bespoke portfolio of debt instruments that is structured based on each client's preferred duration and maturity profile⁵. The three State Government-owned NSPs (Ergon Energy, ENERGEX Limited and Powerlink Queensland) source debt funding from CSPs.

When a client makes a new borrowing or refinances an existing borrowing, QTC sells some of the hedge assets and transfers a mix of QTC bonds from the surplus funding pool to the CSP at

⁵ The duration of a debt instrument equals the present value weighted average term to maturity of the underlying principal and interest payments.

the prevailing QTC market yields. The mix of bonds is based on the duration and maturity profile of the CSP. The cash generated from the asset sale funds the client's borrowing or refinancing requirement.

Each client is responsible for determining the interest rate risk management parameters for its CSP. Clients will often seek QTC's advice when assessing the costs, benefits and risks associated with different CSP structures. Any transactions executed by QTC must comply with these parameters.

QTC cannot provide specific details on the debt management strategies used by the Queensland Government-owned NSPs; however, the strategies are influenced by the way the regulated cost of debt is currently calculated. The NSPs are actively involved in managing the interest rate risk associated with existing and future borrowings. Given the fixed nature of the regulated revenues, the NSPs are focussed on managing the impact of adverse interest rate changes on net profits while keeping refinancing risk at an acceptable level within prevailing market conditions.

How the cost of debt is determined

The total cost of debt paid by an NSP is made up of a base interest rate (referred to as the book interest rate), administration and capital market fees, and a Competitive Neutrality Fee (CNF) paid to Queensland Treasury.

Information on the CNF is available in the *Code of Practice for Government Owned Corporations' Financial Arrangements*, which is available on Queensland Treasury's website.⁶

The book interest rate is determined by a number of factors including:

- the level of QTC interest rates when the NSP makes a new borrowing and when borrowings are refinanced
- the duration and maturity profile of the debt instruments held in the CSP, and
- hedging activities undertaken by the NSP, including the use of forward starting loans and inflation swaps.

The book interest rate can be broadly viewed as a dollar and duration weighted average of the QTC market interest rates associated with the borrowing, refinancing and hedging transactions undertaken by the NSP.

QTC response to claims made by the EURCC

QTC would like to address two claims made by the EURCC in relation to government-owned NSPs, specifically:

1. That *embedded debt costs are not relevant for government-owned NSPs*⁷

⁶ <http://www.ogoc.qld.gov.au/goc-policies/code-of-practice-gocs-fin-arr.pdf> (refer Attachment 2)

⁷ EURCC submission – page 18.

This is incorrect. The actual cost of debt paid by an NSP reflects the interest rates associated with its past borrowing, refinancing and hedging transactions, and the average duration of the borrowings. The transactions initiated by an NSP do not impact the total cost of debt for the other NSPs or CSP borrowers.

2. That⁸ *NSPs have no control over the debt on their balance sheet since it is arranged and managed by the state government treasuries. As such, the government-owned NSPs are unable to respond to regulatory incentives to minimise their debt costs. Therefore there is no loss to efficiency incentives, if the return on debt for government-owned NSPs is based on the actual cost of debt raised by their respective state government treasuries.*

This statement is not consistent with how the NSP debt is arranged and managed in Queensland and, in QTC's view it undermines the basis for the EURCC's proposal in relation to government-owned NSPs. In particular:

- As each NSP is responsible for servicing its own borrowings, that NSP is actively involved in determining its CSP duration and maturity profile. QTC does not make these decisions for the NSPs.
- The maturity profile of the bonds issued by QTC is based on the individual requirements of clients. As such, the NSPs control the debt on their balance sheets, although market conditions may limit the type and volume of bonds that QTC is able to issue in the market, as is currently the case.
- The NSPs actively manage interest rate risk. This includes the timing of debt refinancings, deciding if and when to hedge future borrowings, and managing risks such as inflation risk. These decisions are made by the NSPs, not QTC.
- The CSP structure and other risk management activities are influenced by the way the regulated cost of debt is currently calculated. In Queensland, the claim that government-owned NSPs cannot respond to regulatory incentives relating to the cost of debt is incorrect.

Appropriateness of EURCC's proposed benchmark for government-owned NSPs

The EURCC has proposed a benchmark cost of debt equal to a twelve month average of daily market yields on three to seven year state government bonds, which is to be re-calculated annually. QTC considers this benchmark to be inappropriate for the following reasons:

1. There is no practical funding strategy that can be used to produce an actual cost of debt equal to the benchmark. When the benchmark cost of debt is updated each year all earlier yields will drop out of the calculation. However, if the NSP is funded by bonds with a term to maturity of three to seven years, the fixed yields on these bonds will, by construction, be reflected in the NSP's actual cost of debt for the next three to seven years (as opposed to the twelve month period implied by the EURCC's proposal).

⁸ EURCC submission – page 41.

2. The benchmark assumes that the actual and regulated costs of debt are independent, which does not recognise that actual NSP funding strategies are influenced by the way the regulated cost of debt is calculated.
3. The benchmark is based on an incorrect assumption that embedded debt costs are irrelevant.
4. In addition, the proposal may result in more volatile network charges due to changes in interest rates during the preceding twelve months. Energy users would be more exposed to ongoing interest rate risk in electricity prices.

Removing the DRP from the regulated cost of debt

The EURCC has also proposed excluding a DRP from the regulated cost of debt for government-owned NSPs. All else being equal, this could result in energy users who are served by government-owned NSPs paying lower network charges compared to those served by privately-owned NSPs.

This proposal contravenes nearly two decades of National Competition Policy reforms and the overall micro-economic reform framework that has seen significant changes the energy supply industry over the past three decades.

The risk of undertaking commercial activities, including those performed by NSPs, is the same irrelevant of whether the investment is made by government or a private investor and, accordingly, the required return on equity or debt funding is the same in either case.

The EURCC correctly points out that, in a competitive market, the expected return on an investment reflects the systematic risks associated with the investment⁹.

However, QTC disagrees with EURCC's claim that this principle does not apply to monopolies. As a broad objective of regulation is to replicate competitive market outcomes, the regulator should use the same cost of capital principles that apply in competitive markets when setting the regulated WACC for all NSPs. It is generally accepted that for competitive industries involving long-term assets, the cost of capital is based on a ten-year risk-free interest rate and DRP. To replicate a competitive market outcome, the regulated revenues should also reflect a ten-year corporate DRP. These considerations do not depend on the ownership status of the regulated entity.

⁹ EURCC submission – page 31.

Comments on the EURCC proposals for privately owned NSPs

QTC's views on the problems identified by the EURCC and the proposed solutions are outlined in the following sections.

Proposal to use a five-year regulated cost of debt

The EURCC proposes that the regulated cost of debt is based on an index reflecting five-year corporate debt, rather than the current rules that specify a ten-year term. QTC's views on this proposal are as follows:

- QTC does not agree with EURCC's claim that a ten-year regulated cost of debt over-compensates NSPs who have recently been unable to issue longer-term debt. By focusing on the cost of debt in isolation, the EURCC has not accounted for the increased refinancing risk faced by the equity providers.
- As a consequence, QTC does not agree with the proposal to shorten the tenor of the regulated cost of debt from ten to five years.
- Due to a number of anomalies in the EURCC's analysis, the difference between the actual and regulated DRPs reported by the EURCC in Table 5 appears to be over-stated by approximately 150 basis points¹⁰.

Preferred debt issuance practices for NSPs

In support of its proposal to move to a five-year term, the EURCC states¹¹:

'The benchmark requires the AER to use 10 year bonds with a credit rating of BBB+. But in practice NSPs seldomly, if ever, issue 10 year bonds in the Australian debt market.'

The preferred issuance practices of NSPs were discussed at length in the 2009 WACC review. Data presented by the Joint Industry Association (JIA) and Deloitte showed that, prior to 2008, it was common practice for NSPs to issue debt with average tenors of approximately ten years.

The data presented by the EURCC in Table 1 is consistent with these findings¹². The average term at issue for the entire sample and the Australian dollar denominated issues are 10.5 years and 9.7 years respectively. Similarly, the (albeit small) sample of recent bond issues in Table 2 has a weighted average issuance tenor of 7.9 years.¹³

¹⁰ EURCC submission – page 28.

¹¹ EURCC submission – page 42.

¹² EURCC submission – page 14.

¹³ EURCC submission – page 16.

Recent debt issuance activity

Since 2008, the average issue tenors have been closer to five years, although some NSPs occasionally issue for longer-terms when the opportunity is available.

QTC's observation is that this shorter-term issuance is due to a sharp reduction in the availability of long-term debt funding and not a decision by NSPs to reduce interest costs. If cost minimisation was the primary objective, the NSPs would have been issuing shorter-term debt prior to 2007 when the perceived risk of doing so was lower. The data clearly shows this was not the case, suggesting that NSPs have a preference to issue longer-term debt to reduce refinancing risk, despite the higher cost.

Impact of increased refinancing risk on equity providers

Rather than focusing on the cost of debt in isolation, QTC believes the relevant issue is whether the regulated WACC is providing sufficient compensation for the total risk borne by the equity providers. This requires consideration of the impact of increased refinancing risk on the cost of equity.

Refinancing risk is the risk that a borrower cannot refinance a debt that is close to maturity with new debt on the required terms or in a cost-effective manner. Refinancing risk can be reduced by maintaining a diversified debt portfolio with maturing debts being refinanced with longer-term debt. The reduced availability of longer-term debt since 2008 provides clear evidence that refinancing risk has increased.

The WACC is based on the assumption of an optimal capital structure, involving a mix of debt and equity that provides the lowest overall cost. It is commonly assumed that the tenor of debt will match the asset life (ie, no refinancing risk) although where the life of the assets exceeds ten years the common assumption is to use a ten-year cost of debt. An alternative approach is to use a shorter debt tenor and add a premium to explicitly account for refinancing risk. This approach has been adopted by the Queensland Competition Authority (QCA) in recent determinations for Queensland Rail and Gladstone Area Water Board.

The cost of reducing refinancing risk (or, more precisely, the value of reducing refinancing risk) can be estimated by the increase in DRPs for longer-term debt. Using longer-term funding makes this cost explicit in the actual cost of debt however, using shorter-term debt does not eliminate the cost because the level of refinancing risk is higher. On a risk-adjusted basis a borrower should not be able to reduce interest costs simply by issuing shorter-term debt.

Refinancing risk impacts on equity investors because, in the event of a deterioration in funding markets, either the firm's cost of refinancing debt increases or the firm is required to issue equity capital at a discount, diluting the value of previous investors' interest in the firm.

Refinancing risk also impacts on equity investors because of the need for highly leveraged firms to de-lever their balance sheets in response to tightening credit conditions, including by reducing

payout ratios or raising equity capital. Leverage generally increases the returns to equity because the after-tax cost of debt is typically less than a firm's return on productive assets. The need to de-lever is driven by concerns about the availability and cost of debt, the need to maintain the company's credit rating, and investor concerns about refinancing risk. The infrastructure sector in Australia, including regulated networks, has undergone a significant de-leveraging process over the past few years.¹⁴

The increased refinancing risk is not firm-specific. It impacts all capital intensive businesses that normally seek to borrow for the longest tenor possible. This is especially the case for NSPs as the assumed benchmark gearing level of sixty per cent is higher than the market average for all listed entities. As the risk is systematic, it should be compensated by the regulated WACC¹⁵.

If regulated entities switched from an approach of using longer-term debt funding (ie, because they were compelled to do so because of market conditions), this would be perceived by equity investors as involving an increase in refinancing risk, which would increase the beta of the firms and their cost of equity. This outcome is intuitive, as it should not be possible to reduce a company's cost of capital simply by borrowing shorter-term debt. However, it would be difficult to undertake quantitative analysis to isolate the effect of refinancing risk on the cost of equity of NSPs since 2008. Beta is typically measured over a period of 60 months, while the average maturity profile of listed NSPs has been gradually reducing since 2008 as maturing debt is refinanced with instruments with shorter maturities.

Outcomes from the 2009 WACC review

In the final WACC decision in May 2009 the AER decreased the equity beta from the values previously adopted by the AER and other regulators of 0.9/1.0 to 0.8. In confirming a ten-year tenor for the risk-free interest rate and DRP, the AER stated that¹⁶:

'Although shorter maturities are more likely in the current market than previously, due to a lack of liquidity in (particularly long term) corporate bond markets, the AER considers that it is reasonable and appropriate to take a cautious approach and adopt a longer term perspective on the benchmark term assumption.'

In taking a longer-term perspective, QTC considers that the AER was looking beyond the expected increase in shorter-term debt issuance when jointly arriving at the values for the risk-free interest rate, DRP and equity beta. That is, the equity beta was consistent with the level of refinancing risk associated with a benchmark NSP maintaining an average debt issuance tenor of approximately ten years.

Since 2008, market conditions have forced NSPs to issue for average tenors closer to five years. It follows that the equity providers have been exposed to more refinancing risk than is reflected

¹⁴ This is highlighted in graph 4.20 in the RBA's November 2011 *Statement on Monetary Policy*

¹⁵ We consider refinancing risk to be systematic as it affects a broad segment of the market, rather than a particular firm or industry.

¹⁶ 2009 WACC review (final) – page 165.

in the current equity beta, which has been used in all NSP pricing determinations since May 2009.

In QTC's view, the margin between the actual DRPs on shorter-term debt issues and the ten-year DRPs awarded by the AER should be viewed as either compensation for the cost of raising longer-term debt where it is still available, or compensation for increased refinancing risk where the NSP is unable to raise long-term debt at reasonable prices.

Debt costs which are not explicitly compensated

The 2009 WACC review discussed a number of costs associated with the management of interest rate and refinancing risk by NSPs that are not explicitly compensated by the debt raising cost or cost of capital allowances, but are implicitly compensated through the use of a ten-year risk-free interest rate.

It is well known that NSPs use interest rate swaps to manage interest rate and refinancing risk in the context of having a cost of debt allowance set over a 20 to 40 day period once every five years. This practice involves swapping fixed-rate debt issues into floating rate exposures and entering into five-year swaps during each rate reset period to lock in a fixed base interest rate for the term of the regulatory period.

NSPs may also enter into forward starting interest rate swaps during the rate reset period to lock in a base interest rate on future borrowings that will be made during the remainder of the regulatory period. In addition to transaction costs, the interest rates on forward starting swaps will be higher than the prevailing spot swap rate when the slope of the yield curve is positive.

The AER does not provide compensation for the transaction costs or collateral requirements associated with these strategies, or for the incremental interest costs that apply to forward starting swaps. However, the AER acknowledges that NSPs may receive compensation for these costs due to the long-term average term premium between five and ten year risk-free interest rates, which is approximately 18 basis points per annum¹⁷.

As a consequence, even in the case where an NSP raises debt at an average maturity of less than ten years, its total cost of debt including all debt management costs is likely to be higher than is implied simply by the yield at which its debt is issued.

As the NSPs do not, on average, receive the benefit of the term premium once these costs have been considered, QTC considers that any claims of over-compensation should be limited to the DRP.

¹⁷ Final decision – Electricity transmission and distribution network service providers – Review of the weighted average cost of capital (WACC) parameters, May 2009 – page 166.

Potential errors in the EURCC's analysis

QTC considers the EURCC has significantly overstated the difference between the swap issue margins in Table 5 of its submission and the average DRP awarded by the AER¹⁸. As the DRP is a margin above the annualised yield on a ten-year Commonwealth Government security (CGS), the swap issue margins must be converted to annualised CGS issue margins before comparisons can be made. This has been done in Table A using the closing mid-market swap and CGS yields from Bloomberg on each issue date. The swap and CGS yields match the tenor of each debt issue¹⁹:

TABLE A

Issue date	Parent	Amount (m)	Tenor (years)	Swap issue margin	Swap rate on issue date	Total rate on issue date	Annualised total rate on issue date	Annualised CGS rate on issue date	Annualised CGS margin on issue date
10-Jun-08	DUET	\$685	4.0	1.85%	8.21%	10.06%	10.31%	7.11%	3.20%
13-Jun-08	SP Australia	\$535	10.0	1.95%	7.63%	9.58%	9.81%	6.86%	2.95%
16-Jun-08	Spark Infrastructure	\$200	3.0	1.05%	8.04%	9.09%	9.40%	7.16%	2.24%
10-Nov-08	Spark Infrastructure	\$100	2.5	1.03%	4.72%	5.75%	5.88%	4.06%	1.82%
09-Dec-08	United Energy	\$150	5.0	2.20%	4.70%	6.90%	7.02%	3.83%	3.19%
07-May-09	SP Ausnet	\$275	3.0	2.50%	4.30%	6.80%	6.98%	3.92%	3.06%
04-Jun-09	SP Ausnet	\$50	3.0	2.50%	4.50%	7.00%	7.19%	4.14%	3.05%
05-Feb-10	SP Ausnet	\$520	5.5	1.52%	5.57%	7.09%	7.22%	5.06%	2.16%
	Total / Average	\$2,515	5.4	1.81%	6.68%	8.49%	8.69%	5.91%	2.78%

The weighted average swap issue margin of 181 basis points is equivalent to a weighted average CGS issue margin of 278 basis points, and this corresponds to a weighted average issue tenor of about five years. For consistency, any direct comparisons with the DRPs awarded by the AER should be based on the average CGS issue margin, not the average swap issue margin.

To verify the average CGS issue margin we calculated the DRP using the broad A and broad BBB five year Bloomberg Fair Value curves on each issue date. The weighted average DRP for five year debt was 291 basis points, which is in-line with our 278 basis point estimate. In addition, the annualised total interest rate in the sample of bonds is 8.69 per cent, which is not materially lower than the EURCC's estimate of a 'circa 9 per cent return on debt that has been allowed in AER decisions', especially when the significantly shorter maturities are taken into account²⁰.

Comparisons with the DRPs awarded by the AER

In relation to the data in Table 5 the EURCC state that²¹:

'The weighted average margin on this debt – 181 basis points – compares to the Debt Risk Premium (circa 385 basis points) that the AER allowed NSPs in Queensland, South Australia, Victoria and New South Wales.'

¹⁸ EURCC submission – page 28.

¹⁹ In line with market convention, the swap rates for tenors less than or equal to three years are based on quarterly compounding. Swaps with longer tenors are based on semi-annual compounding.

²⁰ EURCC submission – page 27.

²¹ EURCC submission – page 28.

This statement implies that the NSPs have been over-compensated by 204 basis points. We have several concerns with this conclusion, including that:

- Swap issue margins cannot be directly compared to a DRP because the base yield curves are different²²
- The exact source of the 385 basis point DRP is unclear. Since May 2009 the AER has awarded an average DRP of about 350 basis points, and
- The bonds listed in Table 5 were issued between June 2008 and February 2010. The AER made several draft and final determinations over this period where an average DRP of approximately 330 basis points was awarded²³.

QTC believes it is more informative to compare actual CGS issue margins and regulated DRPs that were set over approximately the same time period. This results in a difference of just 52 basis points (330 basis points minus 278 basis points), which is about 150 basis points lower than the EURCC's implied estimate (385 basis points minus 181 basis points).

Whether the 52 basis point margin provides appropriate compensation for the additional refinancing risk associated with a five-year average debt tenor is an open question. QTC does not consider that the EURCC has provided sufficient evidence to support its claims of over-compensation and more detailed analysis is required before any changes that have the deliberate effect of reducing the DRP can be considered.

Finally, it is QTC's view that differences between the actual CGS issue margins and the DRPs awarded by the AER at *subsequent* rate resets cannot be used to justify a shortening of the regulated debt tenor. While QTC understands the issues raised by the EURCC in relation to embedded debt costs, this is a consequence of fully resetting the regulated cost of debt on a forward-looking basis every five years, not the tenor of the regulated cost of debt.

²² A similar error appears to have been made in the data presented in Table 2 on page 16. The swap rates quoted by the EURCC are actually CGS yields, so the EURCC has added swap issue margins to CGS yields. This may explain the 50 basis point difference with the AER's spread estimates as outlined by the EURCC in footnote 6 on page 16. We have not provided further analysis of the data in Table 2 as we believe a small sample of bonds with an A-rating should not be used in isolation to assess benchmark debt costs for a BBB+ rated benchmark NSP.

Furthermore, as the Singapore Government owns 51 per cent of SPI, the DRPs on these issues may reflect a perceived level of support that does not exist for a benchmark NSP.

²³ 2009 WACC review (final) – page 20.

Consequences of moving to a five year regulated cost of debt

In formulating its proposal, the EURCC considered advice from Cambridge Economic Policy Associates (CEPA). When assessing the impact on cost recovery of moving to a regulated cost of debt based on five year maturities, CEPA state²⁴:

*‘As noted elsewhere, this risk already exists owing to the way the companies fund themselves and does not cause concerns for cost recovery. **Also, the upward sloping yield curve means that lower bond yields help offset any re-financing risk.**’*

[emphasis added]

Under the EURCC’s proposal, the additional refinancing risk associated with five-year debt will not be offset because the regulated revenues will also be based on a five-year regulated cost of debt. The offset will only exist if the regulated revenues continue to reflect a ten-year regulated cost of debt.

As the margin between five- and ten-year DRPs represents the cost of reducing refinancing risk, QTC believes maintaining a ten-year regulated cost of debt will:

- provide sufficient compensation if market conditions improve and more longer-term issuance opportunities become available, or
- compensate the equity providers for bearing increased refinancing risk if the NSPs are forced to continue issuing shorter-term debt.

We also note that the EURCC’s proposal will place the NSPs in a difficult situation if market conditions improve and more longer-term debt issuance opportunities become available. The NSPs may forgo these opportunities because the regulated WACC will only provide compensation for a five-year DRP. If this happens it will be the NER – not market conditions – that constrain the choice of tenor. This is not considered to be an acceptable outcome in light of the National Electricity Objective (NEO). It is understandable that market conditions may limit the choice of debt tenor, but it would be inappropriate for the NER to do so.

Proposal to use broad A and broad BBB Bloomberg Fair Value curves

In the absence of a better alternative, a DRP based on the average broad A and broad BBB Fair Value curves may have some merit provided a DRP term premium is added to produce a ten-year DRP.

Estimating the term premium between five- and ten-year DRPs is a challenging task due to the lack of observable data. One approach could be to compare pairs of shorter- and longer-term bonds issued by the same company to estimate the term premium. Alternatively, a survey-based approach may be a way of dealing with this problem. For example, a panel of financial market participants who are actively involved in the domestic debt capital markets could be asked to provide estimates of the DRP term premium. As these participants are in daily contact with a wide range of investors and corporate borrowers, they should be able to provide a reasonable

²⁴ CEPA Final Report – October 2011 – page 19.

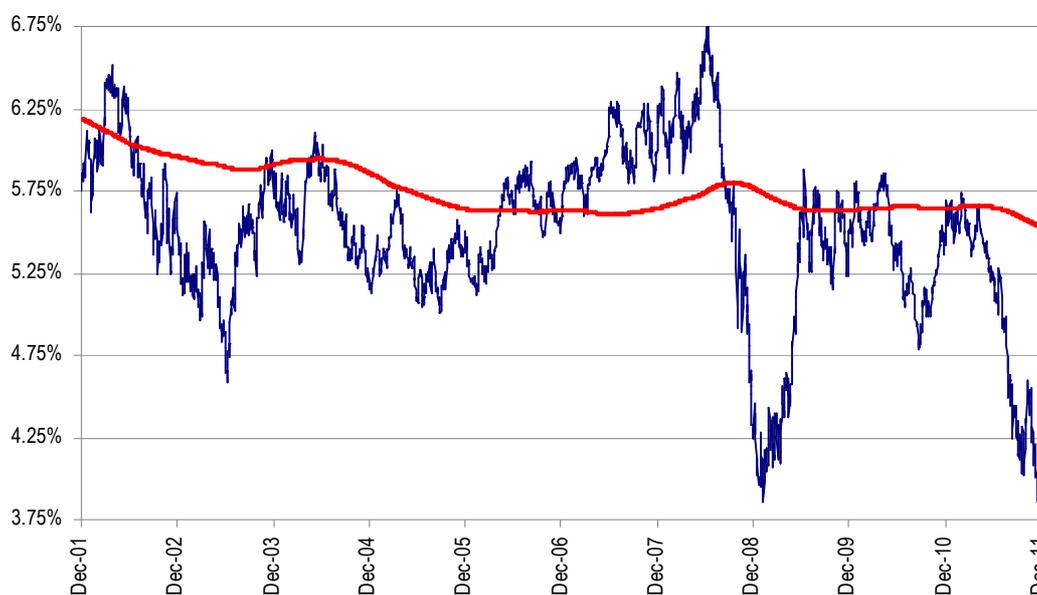
indication of where a new corporate borrowing would be priced in the current market, even if no such borrowings are taking place.

Proposal to base the regulated cost of debt on a five year moving average

QTC shares the EURCC's concerns in relation to the current practice of fully resetting the regulated cost of debt over very short time periods every five years. QTC has consistently been of the view that this approach exposes energy users to the risk of prices being set during periods of elevated risk-free interest rates and/or DRPs. Using a moving average is one way to address this problem. In September 2008, QTC made a proposal based on this approach as part of the AER's WACC review.

Similarly, NSPs are exposed to the risk of the cost of equity being set during a period of relatively low risk-free interest rates, as is currently the case:

**Annualised 10 year Commonwealth Government bond
spot yield and 5 year moving average**



Data source: Bloomberg

The ten-year CGS yield is currently trading at 4.0 per cent, which is approximately 150 basis points lower than the five-year moving average. If a pricing determination were to occur today the regulated cost of equity would be 9.2 per cent assuming an equity market risk premium of 6.5 per cent. While QTC shares the EURCC's concerns, QTC also believes that a balanced view that jointly considers the regulated cost of debt and equity needs to be taken.

Although QTC does not agree with use of a five-year tenor for the regulated cost of debt, the EURCC's proposal to use a five-year moving average could be given further consideration. Further discussion of the following matters would be useful:

- whether the risk-free interest rate used to calculate the regulated return on equity should also be based on a five-year moving average
- whether updating the WACC annually will create additional complexity in the administration and determination of the regulated revenues, and
- the transitional arrangements that would be required, given that most NSPs are likely to have already put in place debt financing and risk management strategies that reflect the current rate-setting methodology.

Estimates of excessive profits to NSPs

There is no evidence of excessive profits for Queensland Government-owned NSPs:

- the return on average assets for ENERGEX was 6.8 per cent in 2011 and 5.8 per cent in 2010 before asset revaluations, or 9.6 per cent and 7.8 per cent respectively when asset revaluations were taken into account, and
- the return on average assets for Ergon Energy before revaluations was 8.0 per cent in 2011 and 5.7 per cent in 2010; with revaluations the figures were 13.8 per cent in 2011 and 6.6 per cent in 2010.

With the exception of Ergon Energy's 2011 result, which includes a large revaluation of property, plant and equipment, the return on assets earned by the Queensland NSPs have typically been below the WACC allowed in the latest determination.

It is also noted that care needs to be taken when comparing NSP cost of debt estimates for the 30 June 2010 financial year to cost of debt allowances for the regulatory period commencing on 1 July 2010. The cost of debt for Queensland NSPs for the year ended 30 June 2010 was largely based on refinancing undertaken around the time of the 2005 regulatory reset, and the CNF was set based on lower prevailing credit margins in 2005.

ENERGEX's latest financial report shows that the weighted average cost of debt has increased to 6.93 per cent in the year ended 30 June 2011. Ergon Energy's latest financial report shows a weighted average interest rate of 7.14 per cent for the year ended 30 June 2011. As the reported figures are based on quarterly interest payments, the annualised debt costs are 7.11 per cent and 7.33 per cent for ENERGEX and Ergon Energy, respectively.

Assessment of the EURCC's expected costs and benefits/delivery of NEO

The analysis above has shown that the differences between the DRPs awarded by the AER and the actual cost of debt raisings are not as significant as suggested in the EURCC's submission. To the extent that NSPs have used shorter-term debt funding, QTC is of the view that:

- this is likely to have been driven by adverse market conditions rather than an attempt to reduce interest costs
- the optimal funding strategy for NSPs has not changed (ie, long life assets should be funded with long-term debt)
- the use of shorter-term debt increases refinancing risk and, therefore, it does not lower the NSP's overall cost of capital, and
- the current use of ten-year corporate debt term does not over-compensate NSPs when all costs and risks are considered.

QTC considers that the current NER requirement for a ten-year corporate debt margin remains appropriate. The use of a five-year cost of debt as proposed by the EURCC may not advance the NEO if it under-compensates NSPs for the cost of longer-term debt. QTC is concerned that this proposal could impact the systematic refinancing risk of NSPs, which would in turn increase the required cost of capital and the long run cost to electricity users.

QTC considers that the consideration of alternative approaches to estimating the DRP, potentially involving the use of a broader range of corporate bond data, would increase stakeholder confidence in future DRPs awarded by the AER.

Comments on the AER's proposal for all regulated NSPs

The AER has proposed that it should be allowed to determine the DRP during a periodic WACC review and that current requirements relating to the calculation of the DRP should be removed. Although the AER is proposing that the DRP will be calculated as part of the WACC review, it has not provided any details or guidance in its rule change proposal as to how the DRP might be calculated.

QTC agrees with the AER on a number of issues with the existing definition of DRP, including the lack of sufficient market data and uncertainty regarding the extent to which securities that are similar to the benchmark ten-year corporate bond can be considered.

To some extent, recent decisions of the Australian Competition Tribunal have clarified the approach that the AER should take in relation to some of the above matters. These decisions found that the AER had been overly restrictive in its interpretation of the definition of DRP and, had it taken a different approach that may have alleviated some of the concerns around the lack of available data.

Further, in the draft determinations for Aurora Energy and Powerlink Queensland, issued on 29 November 2011, the AER has departed from its previous reliance on Bloomberg, using instead a sample of Australian corporate bonds with maturities and credit ratings that are similar to the benchmark bond. While it is too early to assess the merits of the AER's proposed approach, it illustrates that the AER may not be constrained by information issues to the extent that is set out in its submission.

QTC considers that problems relating to insufficient information could be addressed by providing some flexibility to consider a broader range of sources or using data for similar securities, either as a primary means of estimation or as a 'cross check'. In light of the recent draft determinations for Aurora Energy and Powerlink, it may be the case that the current rules already provide sufficient scope to consider a range of information sources. QTC notes that the AER has not identified any specific proposals that might address the data issues (rather, this is left to the WACC review), which makes it difficult to comment on the implications of the AER proposal.

Issues of concern

The AER has clearly indicated its concerns that the current approach to calculating the DRP gives rise to several additional issues.

QTC however, considers that there is insufficient evidence provided to support this view.

Differences between actual and allowed cost of debt

The AER's proposal suggests that the allowed cost of debt over-compensates NSPs because recent data provides evidence of lower DRPs on actual debt issuance. As discussed earlier, QTC assessment is that NSPs are not being over-compensated on a risk-adjusted basis when the impact of increased refinancing risk is taken into account.

Determination of a benchmark debt portfolio

The AER's proposal states that:²⁵

'The NER prescribe that the AER must refer to a benchmark corporate bond rate, the yield of which in practice bears little resemblance to what would be an efficient cost of debt for electricity networks. In part, this reflects the AER's decision to set a benchmark yield to maturity of 10 years, which became immediately problematic during and after the global financial crisis when the market for long dated bonds was highly limited.'

This statement implies that the AER has formed a view on 'what would be an efficient cost of debt for electricity networks' however, it has not provided any information in its submission on this benchmark and how it has been determined. In its recent review of the debt margin, the Independent Pricing and Regulatory Tribunal (IPART) was unable to obtain clear evidence as to the benchmark utility's funding practice²⁶, which suggests that there may be problems applying the AER's approach in practice. QTC is concerned that there is insufficient detail provided to adequately evaluate the potential implications of the AER's rule change proposal.

The discussion on page 78 of the AER's submission implies that, if the rule change proposal was granted, the AER would formulate a benchmark cost of debt based on benchmark debt portfolio held by an NSP from time to time. The proposal states:

'The regulatory framework should be flexible to adapt to what is current practice. Moreover, as benchmark financing structures can change over time, the AER is not simply proposing to replace the existing benchmark (ie, corporate bond rate) with another, but proposes for this to be considered from time to time in the WACC review.'

The AER's proposal notes that the current ten-year benchmark reflected current practices and market conditions at the time.²⁷ However, the drafting of chapter 6 links the maturity of the corporate bond to the maturity of the risk free rate, rather than to the finance practices of the firm. It is not clear whether the link between the maturity of the risk free rate, corporate bond and prevailing funding practices at the time is merely coincidence, or whether the NER intended that the latter two should be linked.

In contrast to the ongoing changes in funding markets, finance theory in relation to the optimal funding of assets has not changed. The AER has not provided any evidence for its contrary claim that the current approach no longer reflects finance theory²⁸. The prudent approach is to

²⁵ AER submission – page 65.

²⁶ IPART 'Developing the approach to estimating the debt margin, Other Industries – Draft Decision', February 2011 page 25.

²⁷ AER submission – page 78.

²⁸ AER submission – page 82.

fund an asset with debt with a maturity equal to the asset life. The practical limitations generally restrict the maturity to around ten years, or less in recent times however, the typical approach to asset or project valuations still involves the use of estimated ten-year corporate debt margins.

Under the approach suggested in the AER's proposal, it appears that the benchmark portfolio would be based on the actual portfolios of NSPs at the time of the WACC review. Based on the recent issuance data provided in the AER's submission, this suggests that the AER could determine that a shorter-term benchmark portfolio should be used to estimate the DRP.

As discussed previously in relation to the EURCC proposal, the use of shorter average maturity debt portfolios increases refinancing risk, which in turn is likely to be reflected in an increased cost of equity. The AER's statement implies that the use of shorter-term debt is an arbitrage profit, when the existence of refinancing risk suggests that it is not.

It appears that the AER is proposing to use the actual financing practices as a means of setting the benchmark portfolio, without enquiring as to whether these financing practices are, in fact, efficient. When a corporate treasurer decides to raise shorter-term debt in response to prevailing market conditions, this may be an appropriate response, but it may also represent a move away from the treasurer's optimal or efficient funding portfolio.

The AER has not provided sufficient information to assess whether calculating the DRP based on actual financing practices in the period leading up to the WACC review will provide a better outcome, other than reducing the difference between the allowed DRP and margin paid on recent NSP debt issuance.

In contrast to the optimal funding strategy suggested by corporate finance theory (ie, long term debt), actual funding strategies will vary continuously based on market conditions, particularly the availability and pricing of debt of different tenors and structures in different markets. When market conditions permit, QTC would expect that NSPs would seek to issue longer-term debt in order to reduce refinancing risk. The AER has identified that market conditions may change between WACC reviews and that this is a shortcoming with their proposal.

In QTC's view, a broader analysis is required to assess all of the costs and benefits associated with moving away from an incentive benchmark that is independent of funding practices to an approach that appears to be directed at compensating for actual debt costs.

Assessment of the AER's expected costs and benefits – delivery of NEO

In our view, the AER has not given sufficient consideration to the potential impacts of its proposal to formulate the DRP as part of the WACC review. In particular, the AER's proposal gives rise to considerable uncertainty for NSPs and providers of debt and equity capital.

The AER appears to be focused on ensuring that the cost of debt allowance reflects recent actual transactions. However, in doing so, the AER is introducing uncertainty that may increase the cost of capital for NSPs and fails to take into account the refinancing risks/costs associated with this proposal.

While there may be short-term benefits for consumers if the AER is able to reduce the return on debt allowed to NSPs, the NEO requires consideration of the 'long-term interests of consumers'. If there is increased uncertainty for investors because the cost of debt allowance can be fundamentally changed in between WACC reviews, the cost to NSPs of raising debt and equity capital may increase. QTC is concerned that this could ultimately lead to higher prices for consumers.

Implications of uncertainty

QTC considers that the AER's submission does not provide a reasonable assessment of the increased uncertainty associated with determining the DRP as part of the five-yearly WACC review. The AER concedes that there will be increased uncertainty for networks leading into each WACC review, but places more emphasis on the certainty and stability that will be provided during the term of the WACC review decision.

We would argue that the prospect of having certainty over a five year period is irrelevant to debt and equity investors who are investing over a longer time horizon. In this regard, all of the recent debt issues in Table 2 of the EURCC's submission were for terms of longer than five years.

The implications of changing the DRP calculation methodology need to be considered in the context of the significance of the cost of debt allowance as a proportion of network revenues. This is particularly the case where the DRP methodology could be subject to continual change at every WACC review. This point was noted by Standard & Poors:

*Historically, the highly leveraged sector's investment grade credit profile has been supported by our positive view of the predictive regulatory framework underpinning high cash-flow stability. However, this stability may be undermined if rule changes result in capital expenditure cost overruns not being incorporated into asset bases, particularly when added to changes in the calculation methodology for asset return. Moreover, a regulatory regime that periodically introduces changes, in our view, is likely to be a feature of a weaker industry and business risk profile.'*²⁹

²⁹ Standard & Poors 'Australian Energy Regulator's Proposed Rule Changes Could Raise Credit Risks' 6 October 2011, page 1.

Similarly, Moody's Investors Service has recently observed that:

*'The final impact of the proposed rule changes to the DRP and the WACC determination process could shift, depending on some of the finer details on how the new rules will be implemented. The replacement of the existing corporate bond benchmark with another observable and market-based benchmark will likely minimize any impact to the sector, while the adoption of an ad-hoc system that could shift from one parameter review to another could have a significant impact on the predictability of the regulatory regime.'*³⁰

The need for stability is properly reflected in the current approach in the NER to calculating the DRP, and the AER's proposal involves a significant departure. In this respect, we agree with the EURCC's statement that:

*'The AER has not explained why it has not considered other alternatives and why it considers that its approach is superior to the alternatives.'*³¹

The radical nature of the changes proposed by the AER require that it provides a strong case that the benefits for consumers over the long-term, outweigh the increased uncertainty for investors, and that the issues are not capable of being addressed by more incremental changes. While QTC acknowledges consumer concerns regarding perceived over-compensation of recent actual debt costs, it is important to recognise that the stability of the regulatory cost of debt allowance supports the ability of NSPs to raise significant amounts of capital at reasonable rates in an environment of heightened investor risk aversion. There is a risk that a significant shift in the regulatory cost of debt allowance could undermine bond market confidence, leading to significantly higher debt costs in the future, which in turn would lead to higher prices for consumers.

Overall objectives when estimating the DRP

In requesting increased flexibility to estimate the DRP the AER states that:

*'The need for increased flexibility in the current rules is highlighted by the review of most of the AER's recent DRP decisions and that these decisions are producing DRPs which are well above the actual cost of debt for many regulated NSPs.'*³²

If the AER is concerned about the quality or accuracy of their ten-year DRP estimates, then the objective should be to identify better estimation methodologies and data sources, with the focus remaining on trying to produce the best estimate of a ten-year DRP. A lack of observable data does not justify the use of a shorter tenor for the regulated cost of debt.

If the AER considers that consumers are paying excessively high prices because NSPs have recently been issuing debt with an average tenor of five years while receiving compensation based on a ten-year DRP, then this is a different issue. QTC considers that close consideration

³⁰ Moody's Investors Services 'Industry Outlook: Australian Regulated Electricity and Gas Network Outlook 2012', 16 November 2011.

³¹ EURCC submission – page 46.

³² AER submission – page 81.

should be given to the implications of a dysfunctional debt market that is forcing NSPs and their shareholders to bear significantly more refinancing risk when assessing whether the current ten-year benchmark provides adequate compensation in the context of the overall cost of capital allowance. In QTC's view, the interests of consumers are best served when decisions are made that are cognisant of the two-way interactions between the regulatory cost of capital framework and the cost at which NSPs are able to raise capital in the markets.