



New South Wales
Treasury Corporation
ABN 99 095 235 825
Level 22
Governor Phillip Tower
1 Farrer Place
SYDNEY NSW 2000
AUSTRALIA
Telephone (02) 9325 9325
Facsimile (02) 9325 9333
Settlements:
Facsimile (02) 9325 9355
www.tcorp.nsw.gov.au

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Mr John Pierce
Chairman
Australian Energy Market Commission
PO Box A2449
South Sydney NSW 1235

Dear Mr Pierce

Response to Directions Paper on AER/EURCC rule change proposals

On 2 March, AEMC released the Directions Paper on the AER/EURCC rule change proposals. I would like to respond to some of the questions relating to how the cost of debt is calculated.

In its role as the central financing authority for NSW, TCorp provides some \$26bn in debt finance to nine regulated utilities. TCorp's central objective is to provide debt in a prudent and efficient way, having regard to the regulatory environment of each utility.

Meeting the needs of each specific business fits within NSW's overall funding strategy. That is, debt outcomes in the regulated utility sector have a material influence on the maintenance of NSW's AAA credit rating. Importantly also, where the regulatory WACC differs significantly from the utility's actual WACC, it can have an unwelcome impact on the allocative efficiency of new capital investment.

It is TCorp's view that regulatory pricing rules should be consistent with prudent debt management practice and the efficient management of regulated utility businesses.

There are three questions that TCorp would like to address, all relating to the cost of debt:

Question 30: Is the benchmark DRP approach likely to overstate the prevailing cost of debt, having regard to the suggestion that the overstatement may be a reflection of shorter maturity debt leading to a higher refinancing risk for NSPs? What weight should be placed on the views of market analysts on the ability of stock market listed NSPs to out-perform their cost of debt allowances?

It is not surprising, in the aftermath of the GFC, that regulated utility borrowers are finding difficulty in accessing long-dated debt finance. TCorp believes that the effect is temporary, and the empirical evidence strongly endorses long-dated debt tenors have been accessed by utility borrowers.

TCorp has calculated that NSW regulated utility borrowers' average life of new debt is 9.8 years. Further, the CEPA evidence from eight private sector network utilities supports a

five-year average debt term for *existing debt*, which of course suggests that *new debt* is financed to 10 years.¹

In short, TCorp believes that post-GFC debt issuance is not reflective of long-term debt practices. Further, any potential short-term savings are offset by higher refinancing risks and costs.

Question 33: Is the EURCC's proposal of establishing the cost of debt using historical trailing average compatible with the overall framework for estimating a forward-looking rate of return? What are the potential benefits of using a trailing average and do they outweigh the potential costs if the estimate is less reflective of the prevailing cost of debt for NSPs?

As TCorp argued in its submission of December 2011, we support the proposal to use long-term historical trailing averages for estimating the cost of debt. Further, long term historical averages provide a better estimate of future rates of return than 20-day moving averages.

We understand the AEMC may be persuaded by three main theoretical underpinnings to the short term average approach to establishing long term future debt costs. We would like to outline, based on the evidence, why we do not support these arguments.

Firstly, many finance and would-be finance experts will promote the Miller-Modigliani efficient markets hypothesis as a basis of supporting a short period of observation close to the end of the period. The argument goes that the prevailing market rate over that 20 day period embodies all known information and provides the best forward-looking estimate of the rate of return for each of the 5 years thereafter. There are obvious logical holes in that analysis which we believe is supported by the evidence. Using data since 1997, TCorp is able to show that *long-term averages provide a better predictor of future debt costs*. The analysis shows that the long-term average of the Commonwealth bond rate has an average absolute error of 42 basis points for debt costs 1-2 years forward. The 20-day average of the Commonwealth bond rate has an average absolute error of 52 basis points. Counter-intuitively, the longer averaging period provides a better forward-looking estimate of future debt costs than the spot rate short period estimate that the AER currently applies. We would also deduce that long-term averaging can also provide better forward-looking estimates of DRP than short-term averaging. In this way, when compared with a short term sampling period, it can be argued that a longer term historical average provides a cost of debt estimate that better reflects the prevailing market conditions for funds and a better forward looking rate commensurate with prevailing market conditions for each year of the future regulatory control period.

¹ Cambridge Economic Policy Associates, Rule Change Sub-Committee of Energy Users Association Australia, Estimating the Debt Margin, October 2011 Final Report, pp. 15-19.

A second argument advocated by proponents of a short term observation period is that the 20-day moving average approach supports the regulatory neutrality between industry incumbents and potential newcomers. It suggests that any shift to long-term averaging would unfairly discourage new entrants. However, the reality of energy network businesses is that it is an industry of incumbents. That is, the loss of regulatory neutrality is not likely to have significant consequences.

While the theoretical underpinnings in support of the current approach is doubtful, TCorp would similarly argue that short-term averaging has significant negative implications.

From the perspective of consumers, energy prices are unusually beholden to financial shocks. That is, short term averaging introduces an unwelcome volatility to consumer prices.

For large government-owned utilities, the debt portfolios are very large. There is simply not enough swap market liquidity to adequately hedge the portfolio's risk free rate to the regulatory benchmark within the 20-day observation period. Further, there are no market instruments that allow the Debt Risk Premium to be adequately hedged.

To the extent that utilities are unable to hedge debt risks, it introduces a friction between the regulatory WACC and actual WACC. The difference creates an *allocative inefficiency* in the assessment of new capital investment. That is, the NSP will have an incentive to under- or over-invest in new capital.

Finally, for the AER, the short-term averaging approach introduces unwelcome arbitrariness in the timing of the observation period. It also burdens the Regulator with the need to closely analyse, weight and track a specific portfolio of illiquid corporate bonds over the regulatory observation period.

In TCorp's opinion, the averaging period used for establishing the cost of debt should be consistent with a prudent debt management approach and stable prices. Prudent debt management will provide a smooth funding profile to at least a 10 year horizon. The averaging period for establishing the regulated cost of debt should therefore match the 10 year prudent financing period. The proposal would deliver secure funding, more stable regulatory prices and better allocative efficiency.

TCorp has a preference for the Ofgem framework. The Ofgem approach takes the ten year average of ten year debt, for both the risk free rate and the debt risk premium, updated annually. In TCorp's opinion, a mechanism that updates debt cost parameters within the regulatory period would closely reflect the model utility's benchmark funding costs, allowing prices to gradually adjust to any changes in market conditions. Further, it would remove the two sources of potential conflict between the Regulator and NSPs around short-term observation periods.

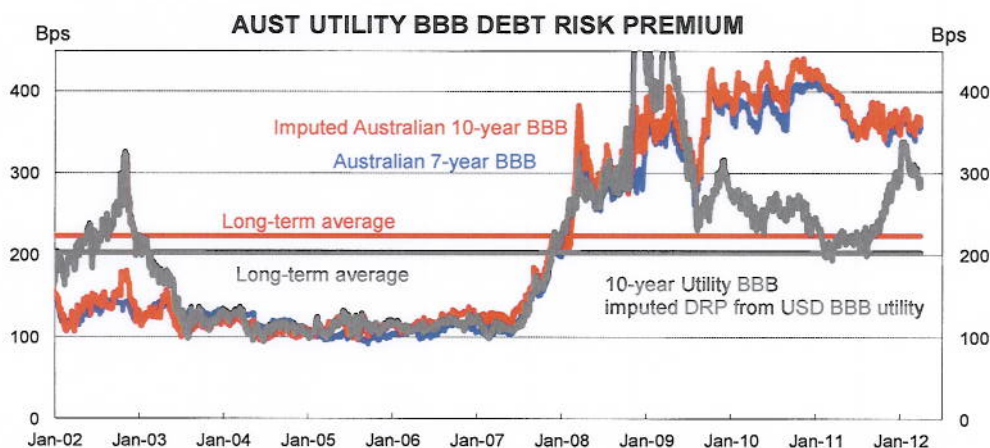
Annual updates would mark a shift from the current framework that establishes a constant rate for each year of the regulatory period and the impact of such a shift would need to be considered further.

Question 34: What possible changes would be required in the NER to implement the EURCC's trailing average approach?

The third argument in support of a shorter observation period relates to the complexity in establishing a proxy for debt costs over such a long term. As the Commission observes, the term to maturity of Australian BBB-rated bonds is no longer comparable to the requirement in the NER. The result has been that the AER has resorted to a range of alternative measures.

In keeping with the recommendation for long-term averages, TCorp proposes to create a proxy ten-year history of ten-year BBB-rated DRP. While Australian utilities frequently borrow to ten years and beyond, they do so typically in US dollars. TCorp has created the DRP estimate using as much Australian data as possible, and augmenting the residual from US corporate debt data.

TCorp uses the Bloomberg Australian BBB seven-year generic series to estimate a seven-year DRP. The Bloomberg US BBB utility seven-year and ten-year rates are swapped into Australian dollars, and the spread to the risk free rate is "spliced" onto the seven-year DRP to create a ten-year DRP.



The average Bloomberg Australian BBB seven-year DRP is 2.10%. The average of the Bloomberg US utility BBB swapped spread between seven and ten years is 12 basis points, taking the ten-year DRP to 2.22%.

TCorp welcomes the opportunity to respond to the AEMC Directions Paper. The global financial crisis has highlighted many areas where the current rules have been shown to be deficient. TCorp believes that the approach that we have proposed would significantly improve the regulatory environment for consumers, utilities and regulators alike.

Yours sincerely
New South Wales Treasury Corporation

A handwritten signature in blue ink that reads 'Michael Allen'.

Michael Allen
Acting Chief Executive