Our Reference: TRX-11872

Mr E Hall
Chief Executive
Queensland Competition Authority
GPO Box 2257
BRISBANE QLD 4001

Dear Mr Hall

Thank you for the opportunity to comment on the Authority's draft decision on Queensland Rail Network's draft undertaking for the 2009 to 2013 regulatory period (UT3).

This submission relates primarily to the Authority's proposed use of a five year term for the risk free asset to estimate QRN's weighted average cost of capital (WACC), while also making some broad comments regarding the role of the QCA moving forward in ensuring a smooth transition to the new public listed entity, QR National.

Regarding the term of the risk free asset, Treasury Department is concerned that the Authority's decision appears out of line with recent regulatory practice and indeed, the past practices of the Authority, potentially diminishing the incentives for the regulated business to adopt best-practice debt management.

In particular, Treasury has concerns that QRN could be disadvantaged in debt markets as a result of this decision, on the basis that it will be faced with a comparatively lower WACC relative to other regulated businesses in the domestic economy. If the QCA maintains its position, there is a risk that lower returns will deter investors from deploying funds into QRN. As a result, the pool of potential investors is diminished as relatively higher risk-adjusted returns are sought elsewhere. This would occur at a time when QRN's reliance on borrowings is anticipated to grow substantially as a result of a record capital expenditure program across the term of UT3.

That the Authority has chosen to vary a previously established regulatory parameter, also impacts on the perceived reliability and predictability of the regulatory regime moving forward. With this decision, it is likely that future capital raisings to fund expansion and maintenance of the network will be affected, as the return on such initiatives diminish. Indeed if investors require too great a risk premium to accommodate this higher perceived regulatory risk, QRN may be unable to fund its expansion and maintenance initiatives in a timely and prudent manner.

This decision also has implications for the manner in which QRN manages its borrowings. Under previous determinations, the Authority's application of the term for the risk free rate which matched the life of the asset as close as possible afforded the regulated business the freedom to manage its financing as it saw fit. However Treasury is concerned that the Authority's draft decision provides incentives for the regulated business to adopt a shorter term debt portfolio with materially greater refinancing risk. For capital intensive entities such as QRN, this may create additional costs associated with more frequent refinancing of large debt portfolios.

The attached submission elaborates on the above points in greater detail.

Transitional arrangements for sale of QR

On 8 December 2009, the Government announced that, QR Limited's (QR's) passenger business, including the metropolitan rail network and the regional freight networks, will be transferred to a new Government-owned Corporation (GOC) known as 'Queensland Rail', while QR's coal and freight business, and the coal network (subject to a long-term lease), will be publicly listed as a vertically integrated company, and will trade as 'QR National'.

As a result, a proportion of QR Networks assets will transfer to the new GOC, Queensland Rail, while the dedicated coal lines will remain within QR Network. This separation will have implications for QR Network's 2009 Access Undertaking.

The Government has clearly articulated that both the publicly listed entity and the GOC will remain subject to the same regulatory regime as is currently in place for QRN. On this basis the Government believes there is an important role for the QCA to ensure the smooth transition of the undertaking in order to minimise uncertainty for both users and the regulated entities. Specifically, the Government wants to ensure there is clarity around the process for access post separation.

As the Government has previously emphasised, the regulatory regime should ensure timely investment in expansions to the network and appropriate maintenance of the network to maximise the efficiency of the coal supply chain.

We urge the Authority to consider the issues raised in this letter and the attached submission, to enable QRN to better manage its business and financial risk and trust that UT3 will be finalised in a timely manner. If you would like further information, your officers can contact Ms Tania Homan, A/Director, Economic and Structural Policy, on (07) 3224 2806 or tania.homan@treasury.qld.gov.au.

Yours sincerely

Gerard Bradley
Under Treasurer

Encl.

Contact: Alex White
Branch: Economic and Structural Policy
Telephone: (07) 3405 6060
Doc ID: C:\NRPortbl\Documents\HC\289779_2.DOCX
Date: 16 February 2010

Queensland Government Submission to the Queensland Competition Authority (QCA) Draft Decision on Queensland Rail Network's (QRN) 2009 Draft Access Undertaking (UT3)

Thank you for the opportunity to comment on the draft decision.

This submission relates primarily to the Authority's proposal to adopt a five year term for the risk free asset and debt risk premium, used to estimate QRN's weighted average cost of capital (WACC) for UT3.

The Queensland Government does not support the proposal to use a five rather than ten year term for the risk free rate, and considers that the Authority has not demonstrated why a shorter term that that traditionally used by regulators is appropriate in this instance, having regard to the material impact on revenues and additional risks this will create for QRN over the course of the regulatory period.

In summary, the Queensland Government considers that a 10 year term for the risk free rate is more appropriate on the basis that it:

- is consistent with regulatory precedent and minimises uncertainty from the perspective of the investor;
- does not put QRN at a competitive disadvantage in capital markets;
- correctly compensates regulated businesses for seeking long term borrowings as a means of reducing its refinancing risk; and
- the long term spread between yields on five and ten year bonds is relatively immaterial.

A detailed discussion of these points follows.

i) Regulatory precedent

As credit markets continue to re-price risk in the wake of the global financial crisis, relative returns are a material issue for investors. The QCA's decision to apply a five year term for the risk free asset is at odds with its past practices and the practices of other domestic regulators.

This will result in, holding other parameters constant, a lower WACC than would otherwise be the case, including if the asset were regulated by the Australian Competition and Consumer Commission (ACCC) or another State regulator. From the Queensland Government's perspective, this will likely put QRN at a material disadvantage relative to other regulated entities in competing for investment capital, particularly as QRN will be undertaking significant borrowings to maintain and expand the below rail network.

The WACC is a measure of the opportunity cost of capital, and is justified as the return required to attract investment away from other comparable investments. That is, it is the return on other similar investments by investors who choose to invest capital in the regulated asset. Regulatory practice as shown below is overwhelmingly in favour of the use of a ten year government bond as a proxy for the

risk free rate. This is how the benchmark WACC is likely to be estimated for other comparable projects, and is the benchmark WACC that investors are likely to consider as the opportunity cost of capital.

If QRN's WACC is going to be assessed relative to the WACC of other regulated entities, it is important to know how WACC parameters are estimated in practice and that this measure remains as predictable as possible over time. The following is a list of decisions that demonstrate standard industry practice in setting the term for the risk free rate:

- The Australian Competition Tribunal's 2003 review of the ACCC decision on GasNet's access arrangements confirmed the use of a Commonwealth bond with maturity matching the life of the asset as a proxy for the risk free rate. On this basis a ten year term for the risk free rate was considered appropriate;[1]
- The Australian Energy Regulator's (AER) May 2009 review considered a ten year term for the risk free rate appropriate in conducting its review of WACC parameters for electricity transmission and distribution entities operating in the National Electricity Market;[2]
- The Economic Regulatory Authority applied a ten year term for the risk free rate in its June 2009 decision on the regulated WACC to apply for The Pilbara Infrastructure below rail network;[3] and
- The Independent Pricing and Review Tribunal used a ten year nominal Commonwealth bond yield in its 2009 review of the regulated return to apply to the Australia Rail Track Corporation-leased Hunter Valley Coal network.[4]

The use of a ten year rate is not considered contentious, and is widely applied by regulators. These precedents are not presented to undermine the arguments expressed in the Authority's draft decision; rather they are presented here to demonstrate industry practice for other regulated businesses that QRN competes against in the market for private investment. In our opinion this is the most persuasive argument in favour of the Authority retaining a ten year proxy.

Further the changing of a previously accepted regulatory parameter is likely to raise concerns among potential investors as to the future predictability of the regulatory regime. From the perspective of the investor, this creates additional uncertainty around the regulated business, adding to the return necessary to proceed with the investment. On this point the AER in its 2009 review of WACC parameters, while acknowledging the conceptual arguments in favour of a five year term, also noted the importance of regulatory stability and efficient investment in recommending a ten year term for the risk free rate.[5]

ii) Debt management practices of the regulated business

---

[1] ACT Decision, A*pplication by GasNet Australia* , December 2003
[2] AER Final Decision, May 2009.
[3] ERA, *Final Determination on the 2009 Weighted average Cost of Capital for TPI's Railway Network*, June 2009
[4] IPART, *Review of the rate of return and remaining mine life from 1 July 2009*, August 2009
[5] AER Final Decision, May 2009 p.173.

The Queensland Government is concerned that the proposed framework may impact on the efficiency of debt management practices employed by QRN. In setting a cost of debt based on a risk free rate and debt risk premium with five year terms, the QCA is in effect forcing QRN to choose between the:

- higher transaction costs incurred with hedging a long-term exposure to match the regulated cost of debt; and
- increased refinancing risk associated with a shorter term debt portfolio.

Treasury considers that the available evidence supports the view that the efficient benchmark firm does seek to borrow funds with the longest term possible as a matter of preference.

Assuming an upward sloping yield curve (on average), it is acknowledged that longer term debt will in general be more expensive. Despite the higher cost of funds, long term debt may be a preferred source of financing for long-lived assets to mitigate refinancing risk. Of course, the regulated businesses' preference for long term debt is balanced against the desire to minimise the overall cost of debt. The regulated business should however not be penalised for seeking longer tenured debt as part of a diversified debt portfolio.

In support of the view that regulated businesses issue long term debt as a matter of preference, we refer to the Joint Industries Association submission to the AER draft decision on the review of WACC parameters for electricity transmission and distribution businesses. This submission concludes that:

> *"The available evidence strongly supports the view that the privately owned regulated businesses firms tend to issue debt that, on average, has a term to maturity closer to ten years than five years. It should be presumed that this reflects the outworking of competitive forces in capital markets. That is, total risk adjusted costs are minimised by issuing debt of a maturity that is longer than five years."*[6]

Interest rate swaps can be used to synthetically hedge the regulated businesses exposure to match that of the regulated cost of debt. However large borrowers who undertake this hedging strategy can expect to incur very high transaction costs. A regulated business should be able to recover all efficient costs associated with hedging its interest rate risk, should it seek to hedge any longer term exposures as part of a diversified debt portfolio. On this basis, these transaction costs should be classified as operating expenditure and be recovered through regulated revenues.

In support of this we point to the submission from the Queensland Treasury Corporation (QTC) to the AER on its draft decision for the review of WACC parameters. This submission used the example of the Brisbane based Airport Link project to illustrate the costs associated hedging interest rate exposures. This submission offers that:

---

[6] CEG Report for JIA in response to AER Explanatory Statement for Review of WACC parameters, February 2009, p.13.

> *"Approximately $3 billion of swaps were executed on alternate days over a 10 day period through a panel of swap providers. Total transaction costs of 21 basis points above the mid-swap rate were charged. According to the consensus view, spreads are expected to increase further and possibly double from current levels. As the Airport Link swaps were executed in August 2008, transaction costs of at least 50 basis points per annum in the current market represents a reasonable base case estimate."*[7]

Conversely if QRN adopts a shorter term portfolio consistent with the length of the regulatory period, such a portfolio will be less diversified with materially greater refinancing risk than would otherwise be the case. The Authority points out that, while it is responsible for the setting the regulated cost of debt, the actual debt financing and hedging strategies employed remain the responsibility of the regulated business. However through this decision the Authority is effectively providing incentives for the regulated business to adopt a more concentrated debt portfolio to match the regulated cost of debt.

This approach to debt management creates refinancing risk and leads to more frequent refinancing of large debt portfolios by regulated entities. Refinancing by large borrowers on a more regular basis is further likely to signal to the market to increase the cost of debt further. If the Authority persists with this approach, an increase in QRN's equity beta may be warranted in recognition of this additional risk.

iii) Long term average for the credit spread between five and ten year bonds

The Authority's argument for adopting a five year term for the risk free rate is, in part, attributable to the material difference in five and ten year bond yields. While it is true that a ten year rate will provide some over-compensation if the regulated business achieves a five year interest rate exposure, evidence presented by the QTC demonstrates that the longer term average of this difference is not significant (long term average of 0.10%-0.15%).[8]

The QTC analysis, dated February 2009, shows that the term premium between the five and ten year bonds has been declining for several years dating back to September 1994. The analysis demonstrates that any over-compensation arising from the mismatch of the length of the regulatory period with the term of the risk free rate is immaterial and has been steadily declining.

The use of a single period sample to argue for a shorter term for the risk free rate, can lead to a significant under-compensation and mismatch in the forward years of the regulatory period if this single observation is an outlier. Treasury suggests that the use of longer term data may mitigate the risks associated with this approach.

---

[7] QTC Submission in response to AER Explanatory Statement for Review of WACC parameters, February 2009, p.13.

[8] QTC Submission in response to AER Explanatory Statement for Review of WACC parameters, February 2009, p.10.

Concluding comments

In view of these arguments, the Queensland Government urges the Authority to recommend a more conventional approach to estimating the regulated cost of debt for UT3, drawing on established regulatory precedent and the past pricing practices of the Authority. The Queensland Government believes it is important to have consistency and certainty in the treatment of WACC parameters across domestic regulated businesses, in recognition of the competitive market for investment capital in the domestic economy.

We strongly encourage the QCA to revisit this decision, noting that:

- QRN is competitively disadvantaged in the market for investment capital by virtue of the shorter term for the risk free rate and the associated reduction in its WACC;
- A five year term will under-compensate the actual credit margins paid by a benchmark regulated businesses that seeks long term financing as a way of reducing refinancing risk; and
- The long term average of the difference between yields of five and ten year Commonwealth Government bonds is relatively immaterial over the long term.