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17 April 2012

Dr Peter Boxall
Chairman
Independent Pricing and Regulatory Tribunal
PO Box Q290
QVB Post Office NSW 1230

Dear Dr ~~Boxall~~ *Peter*

Response to Sydney Water and Sydney Catchment Draft Determinations

I am writing to you to submit TCorp's response to IPART's draft determinations for Sydney Water Corporation and Sydney Catchment Authority, and in particular to raise a number of technical issues that TCorp has noted in the recent determinations.

In its role as the central financing authority for NSW, TCorp provides some \$26bn in debt finance to nine regulated utilities in the public trading enterprise (PTE) sector as well as providing debt to manage the finances of the general government (GG) sector. TCorp's central objective for regulated utilities is to provide debt in a prudent and efficient way, having regard to its regulatory environment.

TCorp provides extensive analysis and advice around the benchmark debt portfolio of a prudent and efficient regulated utility borrower. That is, TCorp seeks to deliver many of the same goals that IPART seeks to deliver. It is TCorp's view that regulatory pricing rules should be consistent with prudent debt management objectives and the efficient management of regulated utility businesses.

On 16 March, IPART released draft determinations for Sydney Water and Sydney Catchment. In our recent consultations with you we highlighted some concerns that TCorp has around IPART's approach to the draft determinations.

This letter addresses four specific areas where TCorp has concerns around the approach taken to the "financeability" of the WACC estimates of a benchmark utility:

Long term averaging

Most of TCorp's loans are provided to regulated utility borrowers. The *financing profile* of regulated utility borrowers is a central concern to TCorp and to credit rating agencies.

Further, the prudent borrower should seek to achieve a smooth debt profile over the funding horizon. Certainly, it would be imprudent (and indeed impossible) to finance the entire debt portfolio within a 20-day averaging period. But equally, given the size of the

debt portfolios in question, it is implausible to hedge interest costs using derivatives within that narrow averaging period, as implied by the regulatory observation methodology. The true cost of funding a prudent utility borrower is a long trailing average of the relevant interest rate. TCorp believes that ten-year trailing averages best reflect the debt costs of a prudently managed borrower.

The trailing average approach ensures that utility prices are less prone to financial market turmoil and consequently less volatile. The proposed approach also provides better financeability to prudently managed utilities because it reflects average interest rates over the economic cycle, rather than a “point in time” approach.

The main challenge to the trailing average approach is the difficulty in estimating a ten-year BBB debt margin when the Australian corporate bond market is limited to shorter maturities. Australian utilities frequently borrow to ten years and beyond, but they do so typically in US dollars. TCorp has created the Debt Margin estimate using as much Australian data as possible, and augmenting the residual from US data.

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

The average Bloomberg Australian BBB seven-year spread 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 debt margin to 2.22%.

Long term parameters

The prudently managed borrower will seek to achieve a debt funding life that is as comparable as possible to the life of the underlying business assets. Prudent Australian utility borrowers target ten year debt terms, and CEPA¹ evidence from eight private sector network utilities supports the ten year debt term. Similarly for NSW-owned utilities, the average life of new debt in regulated utility borrowers is around ten years.

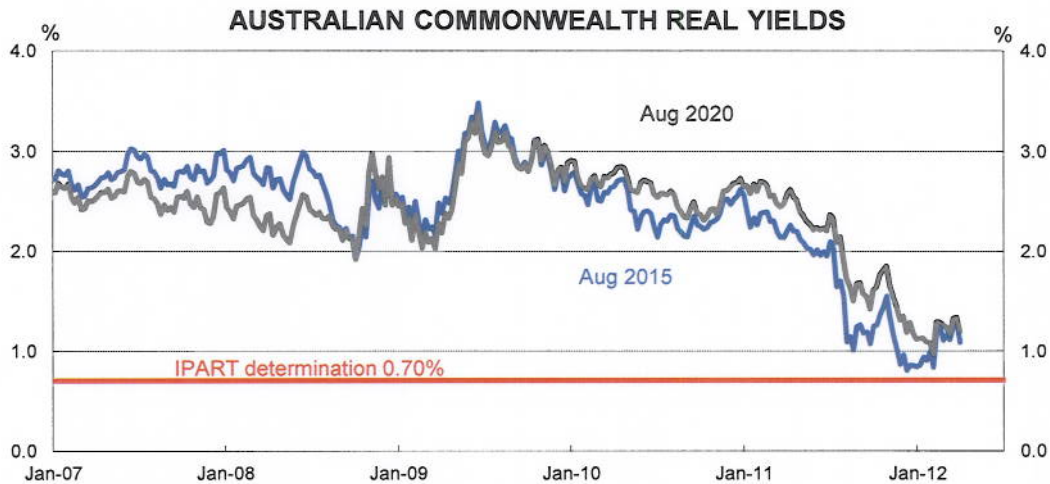
As TCorp has discussed previously², the *cost* of debt relates to the *term* of the debt that is borrowed, not the term of the interest rate reset. For regulatory revenues to reflect the prudent utility’s debt costs, WACC parameters should reflect ten-year rates, not five year rates.

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.

² TCorp, Submission for Sydney Water Final Determination, 24 January 2012.

Real risk free rate and the inflation adjustment

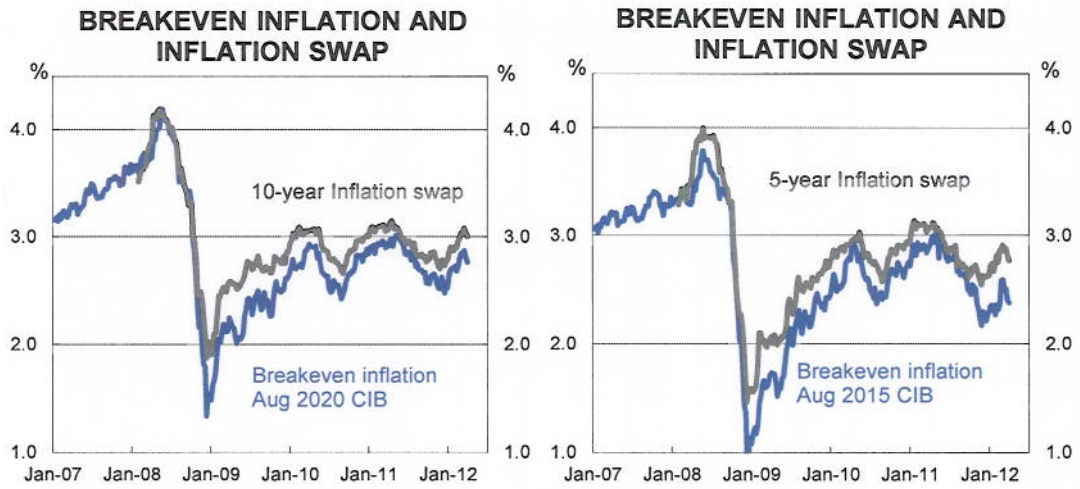
According to the IPART draft determinations, the real risk free rate was observed at 0.70%. A 0.70% real risk-free rate is lower than the Commonwealth (or anyone else in Australia) has ever been able to achieve for any security to any maturity.



IPART has adopted a new approach to estimating the real risk-free rate. Previously, IPART directly observed the yield on the Commonwealth (ten-year) inflation-linked bond. In the draft determination, IPART observes the yield on the Commonwealth (five-year) nominal bond, and subtracts the (five year) inflation swap rate. IPART supports this approach by arguing that the market for inflation-linked bonds is distorted. But bond breakeven inflation rates (BEI) are not directly comparable to inflation swap rates. Since the introduction of inflation swaps in 2008, on average BEIs have been 0.21% lower than the inflation swap rate.

But for a BBB rated swap participant (the regulated utility), the cost of executing the swap is much higher. TCorp estimates the cost of executing a ten-year inflation swap at 0.25%-0.35%. That is, the cost of liability-swapping the nominal bond into a synthetic inflation-linked bond is prohibitive. Without making an adjustment for swap costs, IPART's approach will tend to under-estimate the real risk-free rate by around 0.20%.

TCorp's recommendation for the inflation adjustment is to apply a 2.5% rate, being the centre of the RBA's inflation band. Interestingly, the long-term average of inflation in the period of inflation targeting is very close to 2.5%. Therefore, TCorp's recommendation for the real risk-free rate should be the ten-year trailing average of the ten year Commonwealth nominal rate less 2.5%.



The premium of inflation swap over breakeven inflation rates is consistent with international experience.

Cost of equity and beta

IPART’s draft determination allows a “cost of equity” of 6.6% to 8.5%. The “cost of debt” allowance is 6.8% to 8.1%. TCorp would point out that the “low” estimate for equity (6.6%) is lower than the low estimate for debt (6.8%).

IPART’s regulatory framework is based on the Capital Assets Pricing Model (CAPM). The CAPM theory states that ex ante returns to risky equity must always be higher than less-risky debt. That is, the CAPM model on which the determination framework is based makes it impossible to have an *ex ante* cost of debt higher than the cost of equity.

Conclusions

TCorp believes that the capital cost of a prudent benchmark utility is something that is a primary concern to both our organisations. I hope that a consideration of the issues raised above will lead to greater certainty of outcomes for operators and consumers, greater financeability to regulated water utilities, and underpin the maintenance of the NSW AAA credit rating.

Yours sincerely
New South Wales Treasury Corporation

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

Michael Allen
Acting Chief Executive