Hon Andrew Fraser MP
Member for Mount Coot-tha

Queensland Government

Treasurer of Queensland

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Clerk at the Table:			

The Honourable Martin Ferguson MP
Minister for Resources and Energy
Minister for Tourism
PO Box 6022
Parliament House
CANBERRA ACT 2600

Dear Martin,

I refer to the Australian Energy Regulator (AER)'s current review of the weighted average cost of capital (WACC) for regulated transmission and distribution businesses.

The AER is currently finalising its review of the WACC. As one of the shareholding Ministers for the State-owned transmission and distribution network service providers, I am concerned that, on the basis of the draft position taken by the AER, the regulated rate of return would neither encourage nor sustain efficient levels of investment in the electricity industry.

I find this position troubling given the current period of unprecedented uncertainty in the energy Industry, particularly associated with:

- the impending introduction of a Carbon Pollution Reduction Scheme (CPRS) and expanded Renewables Energy Target (RET) in Australia; and

- the long term financial and economic fallout from the global financial crisis.

If the AER maintains its position on the WACC parameters in the face of this uncertainty, there is a real risk that lower regulated returns would act to deter investors who would otherwise be attracted to the Australian energy industry. As a result, the pool of potential investors would contract as institutions seek relatively higher risk-adjusted returns elsewhere. This would occur at a time when regulated electricity businesses need access to substantial amounts of additional finance to undertake large capital expenditure programs.

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A reduction in the allowable rate of return on energy network investments limits the ability of State-owned networks to fund capital spending from retained earnings and new borrowings. Further, government-owned businesses must make commercial business decisions, just like any other business. This includes undertaking investments on the basis of risk-adjusted rates of return.

The economic modelling on the Australian Government's CPRS and RET, undertaken by Commonwealth Treasury and McLennan Magasanik Associates, for example, has explicitly assumed that transmission grid upgrades would occur as and when needed. Without these upgrades:

- the CPRS pathway may not be achieved at least cost; and
- it would act as a serious impediment to achieving the RET, or the RET will occur but at substantially higher cost.

On a separate but related issue, I am as yet unconvinced about the workability of the methodology proposed by the AER for determining the cost of debt for regulated entities. Its approach implicitly requires regulated businesses to implement costly and imprudent risk immunisation strategies should they wish to protect their earnings against adverse movements in interest rates. This problem is compounded by virtue of the significant size of the debt portfolios involved, approximately $14 billion for Queensland's distribution businesses ENERGEX Limited (ENERGEX) and Ergon Energy Corporation Limited (Ergon Energy), and the current state of the corporate debt market.

I wrote to the Commonwealth Treasurer on this matter in late 2008. The Queensland Treasury Corporation (QTC), on behalf of the Queensland Government indicated its serious concerns to AER in September 2009, and as the State's central financing authority and advisor on financial risk, proposed an alternative approach. This involved the WACC being recalculated annually rather than set for the term of the regulatory period, which would result in a staged approach to the setting of regulated revenue.

In its draft decision, the AER rejected QTC's proposal, noting that the National Electricity Rules precluded the implementation of such a framework. However, the AER indicated it was willing to consider the possibility of incorporating hedging costs within a regulated entity's operating cost allowance. Any decision in this context, would be made outside of the current WACC Review, and as part of each businesses' regulatory determination.

At this point in time, the extent to which the AER will recognise the full debt-related transaction costs incurred in matching the regulated cost of debt and managing interest rate risk is still largely untested, and provides no real certainty for the regulated businesses. This matter will need to be determined during the forthcoming AER Distribution Review for ENERGEX and Ergon Energy.

Depending on the AER's final approach, the Queensland Government may seek future consideration of the need for an accommodating change to the National Electricity Rules to allow regulated businesses to more effectively manage their interest rate and refinancing risk.

The Queensland Government is raising issues regarding the unsatisfactory draft WACC determination and its implication for the investment environment in its submission to the AER. I am forwarding a copy of this letter to Mr Steve Edwell, for information.

Yours sincerely

ANDREW FRASER