Gladstone Area Water Board FY26–FY30 price monitoring investigation

17 February 2025

QUEENSLAND TREASURY CORPORATION

Summary

- Queensland Treasury Corporation (QTC) welcomes the opportunity to provide comments on the Queensland Competition Authority's (QCA) draft report on its price monitoring investigation of the monopoly business activities of Gladstone Area Water Board (GAWB) for the period 1 July 2025 to 30 June 2030.
- QTC does not agree that the Referral Notice requires the QCA to use a simple trailing average approach (rather than a weighted trailing average) to determine GAWB's allowed cost of debt:
  - The Referral Notice requires the QCA to use the Australian Energy Regulator's (AER) 10-year transition from an 'on-the-day' cost of debt to a 10-year trailing average cost of debt.
  - The QCA's preferred simple trailing average only applies the AER's transition to GAWB's opening debt on 1 July 2025. The AER's transition is not applied to subsequent increases in GAWB's benchmark debt because each increase is not initially compensated at the corresponding prevailing 10-year BBB yield.
  - In contrast, QTC's weighted trailing average approach is identical to applying the QCA's simple trailing average, and the AER's 10-year transition, to opening benchmark debt on 1 July 2025 *and* to each subsequent increase in benchmark debt, and aggregating the results into a single cost that applies to total debt.
  - In QTC's view, a weighted trailing average is more consistent with the requirements in the Referral Notice compared to the QCA's preferred simple trailing average.
- QTC notes the changes made in September 2024 to the QCA's approach for extrapolating the Reserve Bank of Australia's (RBA) BBB debt risk premium (DRP) to an exact 10-year tenor. Although the changes remove the downward bias in the previous approach, the QCA's approach is unnecessarily complex and difficult for stakeholders to replicate.
  - Consistent with our previous submission, it is QTC's view that linear extrapolation of the RBA's BBB total yields, rather than DRPs, is the simplest and most accurate way to estimate the benchmark 10-year BBB yield.

1. The Referral Notice does not preclude the use of a weighted trailing average approach

- Whilst acknowledging the shortcomings in its preferred cost of debt approach, QCA continues to apply the simple trailing average, based on a perceived alignment with the Referral Notice[1]:

> Consistent with the referral notice and the methodology outlined in our rate of return review, we consider it reasonable to apply a simple trailing average for calculating the cost of debt. Nonetheless, we accept that there is a legitimate issue where the marginal cost of new debt raising is materially higher than the average cost of historic debt. We note that this could be a disincentive to undertake large capital investments

[1] QCA, *Gladstone Area Water Board price monitoring investigation – Draft report.* November 2024. p 84.

(especially when significant construction risks are borne by the business) relative to the regulated asset base. **Notwithstanding this, we have applied the requirements outlined in the referral notice.**

- QTC does not agree with the QCA's implied framing that the Referral Notice is a constraint on the form of the trailing average cost of debt approach.

1.1 Cost of debt transition

- The Referral Notice requires the QCA to use the AER's transitional approach for moving from the on-the-day to a trailing average cost of debt allowance[2]:

> For estimating the cost of debt, a 10-year transition from the 'on-the-day' approach to the 'trailing average' approach (consistent with the Australian Energy Regulator's transition arrangements) applies.

- The QCA's simple trailing average only applies the AER's transition to GAWB's opening debt on 1 July 2025. The AER's transition is not applied to subsequent increases in GAWB's benchmark debt because each increase is not initially compensated at the corresponding prevailing 10-year BBB yield.
- As highlighted in QTC's initial submission, the AER has made specific observations on how a trailing average can be implemented for a firm with benchmark debt that is increasing over time:[3]

> 'The [simple] trailing average implicitly assumes firms raise 10% of their debt capital each year on a rolling basis. However, where firms make large new investments this assumption does not hold. In this situation, and where interest rates have changed significantly over the period of the current trailing average, firms may be materially incorrectly compensated on these new investments.
>
> A resolution to this issue is to **provide all new investments the spot rate on debt and then transition these new investments to a trailing average. This would be consistent with our approach when we introduced the trailing average in our regulatory determinations post 2013**. For all decisions made since 2013 we have started (or continued) the transition of the return on debt from the 'on the day', or spot rate, to a 10-year trailing average over 10 years.'

- QTC's weighted trailing average approach is identical to applying the QCA's simple trailing average, and the AER's 10-year transition, to opening benchmark debt on 1 July 2025 *and* to each subsequent increase in benchmark debt, and aggregating the results into a single cost that applies to total debt.
  - The workbook that forms part of QTC's previous submission included a work example that demonstrates the equivalence of QTC's weighted trailing average and the approach outlined above by the AER.
- There is no reason to treat opening benchmark debt on 1 July 2025 differently from each subsequent increase in benchmark debt. All debt should initially be compensated at the corresponding prevailing 10-year BBB yield, followed by a 10-year transition to a full 10-year trailing average. This is what happens under QTC's weighted trailing average approach.
- In QTC's view, a weighted trailing average is more consistent with the requirements in the Referral Notice compared to the QCA's simple trailing average.

[2] Deputy Premier, Treasurer, Minister for Trade and Investment. *Amending Referral notice.* May 2024. p 4.
[3] AER, *Consultation on TransGrid and ElectraNet participant derogations – Financeability of ISP projects*, December 2020, p. 17.

2. Estimating the benchmark 10-year BBB yield

- QTC notes the change made to the QCA's approach for extrapolating the cost of debt to an exact 10-year tenor. By calibrating the effective tenor of the BBB yield and equivalent CGS yield, QCA's DRP extrapolation now produces an unbiased estimate of the benchmark 10-year BBB yield.
- As highlighted in QTC's initial submission, the QCA's approach of interpolating CGS yields and producing unbiased DRPs is a data and calculation intensive process. Whilst acknowledging the considerable resources QCA have deployed in developing the cost of debt estimation methodology, in QTC's opinion the approach is unnecessarily complex and difficult for stakeholders to replicate.
- In QTC's view, linear extrapolation of the RBA's 7-year and 10-year BBB total yields and effective tenors remains the simplest and most accurate way to estimate the BBB yield for an exact 10-year tenor. Compared to the QCA cost of debt estimation process this is a relatively simple approach that produces near identical estimates[4], with greater transparency and ease of replication for stakeholders.

[4] QTC. *Gladstone Area Water Board FY26-FY30 price monitoring investigation – submission.* August 2024. Figure 3. Page 9.

Appendix A: Rationale for the weighted trailing average approach

- Having established that the Referral Notice does not preclude the use of a weighted trailing average, it is QTC's view that the QCA should reconsider the merits of a weighted trailing average approach.

A.1: Conceptual consistency

- The QCA has not explained why, under its preferred simple trailing average approach, two different costs of debt should be applied to two benchmark debt transactions that occur at the same time[5]:

> 'A simple trailing average is an inconsistent return on debt approach because it compensates two new borrowings that are made at the same time at different costs of debt. The annual refinancing of 10 per cent of the existing debt balance is compensated at the prevailing cost of debt, while the increase in the debt balance for the same year is compensated at the average cost of debt over the last 10 years.'

- Under a weighted trailing average, new debt is compensated at the prevailing rate, regardless of whether borrowings are for refinancing maturing debt or to fund new investments. In differentiating the compensated cost of debt depending on the underlying borrowing's purpose, the conceptual inconsistency of the simple trailing average approach also distorts the ability of the regulated firm to recover efficient financing costs.

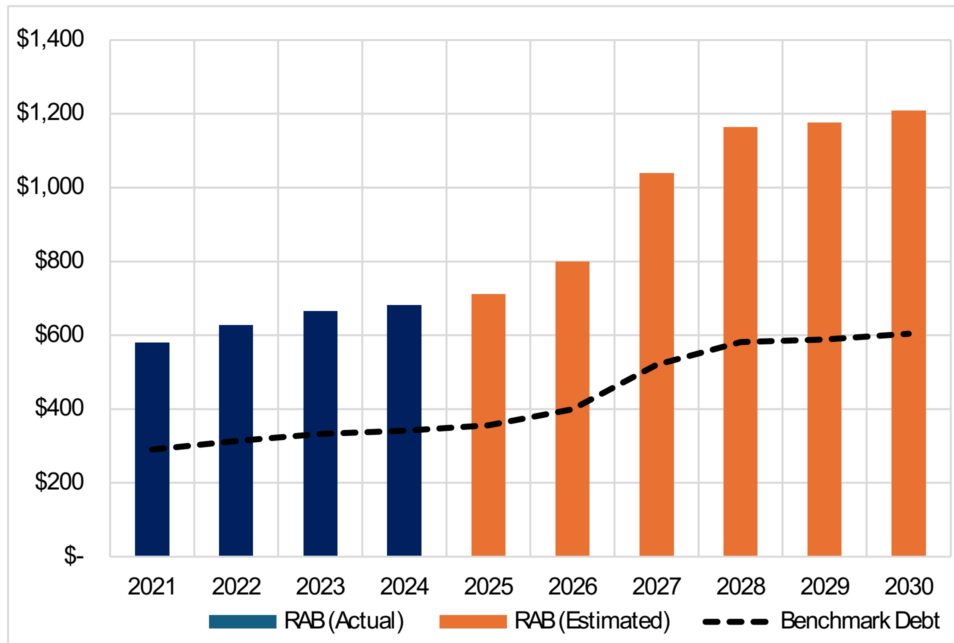
A.2: Correct compensation for efficient financing costs

- QTC's initial submission acknowledged that when benchmark debt levels are relatively stable, the simple and weighted trailing average will produce similar cost of debt estimates.
- Under the QCA draft report GAWB's Regulated Asset Base (RAB) increases from $682M (opening FY25) to $1,208M by the end of the price monitoring period (FY30). This 77 per cent increase represents a step change to the RAB, with a commensurate increase to benchmark debt levels (Figure 1)[6].

[5] QTC, *PTRM-weighted trailing average approach. A Joint Report for Energex and Ergon Energy*, June 2015, p 3. As part of Energex revised regulatory proposal – Jul 2015, Appendix 7.8.

[6] QCA, *Gladstone Area Water Board price monitoring investigation – Draft report.* November 2024. Table 21 p 72. Table 24 p 74.

FIGURE 1: GAWB'S RAB UNDER THE QCA DRAFT REPORT ($'M NOMINAL)



- It is under circumstances such as GAWB's relatively large investment profile that large differences between the two trailing average cost of debt estimates can occur.
- With GAWB's large new investments, the most appropriate way to estimate the efficiently incurred cost of debt is by using a weighted trailing average:
  - QCA's simple trailing average will not provide correct compensation if the 10-year BBB yield differs from the simple trailing average when the investments are added to the RAB, and
  - The QCA's simple trailing average is based on a debt strategy that cannot be implemented in practice – it is not possible to fund a new investment today at an average yield that prevailed in the past.
- If the benchmark firm is regulated under a framework where it is not possible to recover the efficiently incurred cost of debt given the firm's circumstances (ie, large capital investments), there is also the potential for the distortion of investment incentives, as acknowledged by the QCA[7].

A.3: Provision of correct investment signals

- Whilst welcoming QCA's recognition of the potential investment distortion under the simple trailing average approach, it is worth noting that the distortion is not asymmetric:
  - As acknowledged by the QCA, where prevailing rates are higher than average historic rates, there is a potential disincentive to invest for the benchmark firm (ie, to delay investment). [8]
  - However, under the case where prevailing rates are lower than average historic rates there is a potential incentive to invest for the benchmark firm (ie, to bring forward investment).
- QTC's weighted trailing average approach mitigates the distortions to investment incentives that arise under a simple trailing average[9]:
  - A weighted trailing average will provide an allowed cost of debt that is more reflective of the efficiently incurred cost of debt compared to the simple trailing average, and
  - Under a weighted trailing average, the marginal cost of debt that applies to new investment is the prevailing cost of debt. This ensures consistency between the allowed and the efficiently incurred cost of debt for the

[7] QCA, *Gladstone Area Water Board price monitoring investigation – Draft report.* November 2024. p 84.
[8] QCA, *Gladstone Area Water Board price monitoring investigation – Draft report.* November 2024. p 84.
[9] QTC. *Gladstone Area Water Board FY26-FY30 price monitoring investigation – submission.* August 2024. Appendix B. p 15.

benchmark firm,[10] averting the distortion to investment incentives that arises under the simple trailing average approach.

- It is important to note that the correct investment incentives that arise when the weighted trailing average is applied do not exclusively benefit the regulated entity. The investment incentive impacts are symmetrical, equally benefitting customers.

A.3.1: Investment incentives under the simple trailing average

- Under a simple trailing average approach, there is a distortion of investment incentives, with associated windfall gains accruing to either the regulated entity or customer depending on the relationship between historic and prevailing rates at the time the investment is added to the RAB:
  - When prevailing rates are above historic rates, there is an incentive to delay the investment, and customers secure a windfall gain from the regulated entity in the case of the investment proceeding.
  - When prevailing rates are below historic rates, there is an incentive to bring forward investment, and the regulated entity secures a windfall gain from its customers in the case of the investment proceeding.
- These windfall gains, which are a transfer of wealth between the regulated entity and its customers, serve no useful purpose and are the product of poor regulatory design.

A.3.2: Investment incentives under the weighted trailing average

- In contrast, under QTC's weighted trailing average, at the time the investment is expected to be added to the RAB:
  - When prevailing rates are above historic rates, there is no incentive to delay the investment, and customers do not secure a windfall gain from the regulated entity.
  - When prevailing rates are below historic rates, there is no incentive to bring forward investment, and the regulated entity does not secure a windfall gain from its customers.

[10] QTC. *Gladstone Area Water Board FY26-FY30 price monitoring investigation – submission.* August 2024. Appendix B. p 15.