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QUEENSLAND
TREASURY
CORPORATION

Mr Terry Effeney
Chief Executive Officer
ENERGEX Limited
GPO Box 1461
BRISBANE QLD 4001

Mr Ian McLeod
Chief Executive Officer
Ergon Energy
PO Box 15107
CITY EAST QLD 4002

Mr Gordon Jardine
Chief Executive Officer
Powerlink
GPO Box 1193
VIRGINIA QLD 4014

Dear Sirs

EXPERT STATEMENT

1. PURPOSE

This statement is intended to inform the Australian Energy Regulatory (AER) on the debt raising and portfolio management practices of government owned corporations in Queensland in undertaking its review of the Weighted Average Cost of Capital (WACC) parameters for electricity transmission and distribution businesses. We have included our assessment of the state of the debt capital markets and the implications for the way regulated businesses will be required to manage debt portfolios in the future.

2. BACKGROUND

The Queensland Treasury Corporation (QTC) is the Queensland Government's central financing authority and corporate treasury services provider. Founded in 1988, QTC is a corporation sole, constituted by the Under Treasurer in accordance with the *Queensland Treasury Corporation Act 1988*. QTC is responsible for:

- sourcing and managing the debt funding to finance Queensland's infrastructure requirements in the most cost-effective manner, and

- providing financial and risk management advice and services to the Queensland Government and Queensland's public sector bodies (our customers).

In its funding role, QTC borrows funds in the domestic and international financial markets by issuing a variety of debt instruments. The Treasurer of Queensland, on behalf of the State Government, guarantees all of QTC's obligations under all debt instruments issued by QTC from time to time.

3. DEBT MANAGEMENT STRATEGIES USED BY REGULATED CUSTOMERS

At prior determinations, our customers have sought to recover the regulated cost of debt by aligning their average debt term with the length of the regulatory period. The required bonds were typically issued well in advance of the rate reset period and the associated interest rate risk was hedged with physical and/or derivative debt instruments. These bonds were warehoused by QTC until required by the customer. During the rate reset period the interest rate hedges were gradually unwound and the debt transferred to the customer. We understand that privately owned regulated businesses have taken a similar approach whereby funding and interest rate risk are managed separately. The use of interest rate swaps to lock in a fixed borrowing cost during the reset period would require similar market transactions to those used by QTC when unwinding the interest rate hedges. For the reasons outlined in sections 5 and 6 we do not believe that it will be possible to implement our current strategy at future regulatory rate resets.

4. MANAGEMENT OF INTEREST RATE AND REFINANCING RISK

QTC takes a whole-of-State perspective when raising debt and managing refinancing risk. This is achieved by:

- spreading the total borrowing requirement across multiple maturity dates, and
- refinancing borrowings approaching maturity with longer term fixed rate debt.

Interest rate risk is managed by combining physical borrowings and derivatives such as interest rate swaps to form debt portfolios. The mix of instruments is chosen to achieve a modified duration that is consistent with the customer's appetite for interest rate risk.

With regard to refinancing risk it is crucial to distinguish between the remaining term to maturity and the term to maturity when the debt was originally issued. The original term conveys far more information about the way QTC raises debt and manages refinancing risk. The remaining term is arbitrary as it depends on the time at which it is calculated. It says nothing about the tenor of the debt that was actually raised in the market.

The credit margin paid in excess of the yield on a comparable Commonwealth Government bond depends on the term to maturity of the bond and when it was issued. This margin is effectively locked in for the life of the bond. The table on the following page displays the remaining and original term to maturity of QTC's main fixed rate funding instruments as at January 2009[1]:

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[1] QTC usually issues new bonds via competitive tender and gradually adds to these bonds by issuing on a tap or reverse inquiry basis. It has been assumed that approximately $2 billion (or 30% of total outstandings where the

Maturity Date	Face Value (m)	Remaining Term to Maturity (yrs)	Average Term to Maturity When Issued (yrs)
14-Jul-2009	$5,523	0.5	8.2
14-May-2010	$7,264	1.3	3.9
14-Jun-2011	$8,847	2.4	7.9
16-Apr-2012	$3,434	3.2	3.8
14-Aug-2013	$7,727	4.5	8.9
14-Oct-2015	$8,047	6.7	13.4
14-Sep-2017	$5,500	8.6	10.1
14-Jun-2021	$1,159	12.4	19.4
20-Aug-2030	$663	21.6	23.3
14-Mar-2033	$607	24.1	24.7
Weighted Average	**$48,771**	**4.6**	**9.1**

The above table clearly highlights the difference between the debt term at the time of issue and the remaining term at a single point in time.

QTC's customer base consists of regulated and non-regulated entities. In addition, if the entire customer base was regulated the debt profile summarised above would be indicative of how QTC would raise debt in the market to fund these entities. If a customer attempted to align the actual and regulated cost of debt, additional market transactions (such as the use of interest rate swaps) would be required. However, the principle of spreading the total borrowing requirement over multiple maturity dates and seeking to issue longer term debt would not change as this best manages refinancing risk. Interest rate and funding risk would still be managed separately.

5. CHANGING DEBT MARKET CONDITIONS

The domestic and global debt markets have fundamentally changed over the last 18 months as a consequence of the credit crisis, which has now evolved into the global economic crisis which, based on evidence, appears to be worsening each month. Refinancing risk is far more significant and, as a consequence, has greatly impacted the way QTC issues debt. It has become necessary to respond to reverse inquiry investor demand for certain debt instruments as and when this investor interest arises. The importance of seeking to issue for the longest tenor possible has also been highlighted to customers. Although liquidity has fallen sharply, opportunities to issue very long term debt still arise from time to time. In the current market, taking advantage of these opportunities is a prudent and appropriate way of reducing refinancing risk.

Given our substantial debt portfolio, at prior resets QTC has been able to reasonably match the funding profile for our regulated customers as the volume of debt has not previously been of a size which would result in excessive funding risk. However, due to the significant increase in the amount of debt required by these customers, QTC's refinancing task would become heavily skewed towards a small number of bonds. This would eventually increase the risk associated with this strategy to a level which we believe is neither prudent or manageable.

6. IMPACT ON FUTURE DEBT MANAGEMENT STRATEGIES

Reduced liquidity in the physical and derivative debt markets, coupled with significantly higher borrowing requirements, will change the way our regulated customers structure their debt at

volume is less than $2 billion) is issued within the first six months with the remaining balance being borrowed evenly over time. As such, the 'Average Term to Maturity' for each bond is based on multiple borrowing dates.

future determinations. Our customers will be forced to adopt portfolios that differ from those used in the past. Greater emphasis will be placed on managing refinancing risk at the expense of hedging interest rate risk. This will increase the risk of our customers being unable to recover the regulated cost of debt. The current regulatory framework provides no compensation for this risk.

Contrary to the findings of the Deloitte report (Attachment B to the AER's explanatory statement, 'Electricity transmission and distribution network service providers: Review of the weighted average cost of capital (WACC) parameters'), we strongly believe that fully recovering the regulated cost of debt will not be possible for large regulated businesses. There is insufficient liquidity to accommodate the required interest rate hedging transactions. Attempting to do so will incur costs (bid/offer spreads) that are significantly higher than the estimates provided by Deloitte. More importantly, the signals sent to the market by these transactions will encourage other market participants to engage in opportunistic pricing practices – another risk for which there is no compensation under the current regulatory framework.

Sincerely

Stephen Rochester
Chief Executive

DISCLAIMER

QTC has prepared this submission solely for use and consideration by the AER. QTC permits the AER to publish this submission in its entirety on its website. This submission is subject to the assumptions outlined in the submission and the assumption that the current economic, political or commercial environment does not materially alter. Markets are volatile and unpredictable. QTC does not warrant or guarantee any outcome or forecast in this document or arising from reliance on it. Neither QTC nor any of its employees or agents accepts any liability for any loss or damage suffered by any person as a result of that person or any other person placing any reliance on, or acting on the basis of, the contents of this submission.