WESTERN AUSTRALIAN
TREASURY CORPORATION

FINANCIAL SOLUTIONS FOR THE BENEFIT OF ALL WESTERN AUSTRALIANS

Mr Richard Begley
Rate of Return Guidelines Review
Economic Regulation Authority
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Dear Mr Begley,

RATES OF RETURN GUIDELINES REVIEW

We submit for your consideration in the *Rates of Return Guidelines Review* the attached response from the Western Australian Treasury Corporation (WATC).

WATC is the central borrowing authority for the State of Western Australia. The debt it issues attracts the highest credit ratings from the various rating agencies. It benefits from the distribution services of its dealer panel made up of the major financial institutions operating in the Australian debt markets.

In making this submission, WATC's intention is to raise awareness around the practicalities of transacting in the Australian debt markets, in particular, the challenges that can arise in refinancing or swapping large tranches of debt within a short regulatory window.

While WATC has no stake in the outcomes of the ERA consultation and regulatory processes, the ERA may benefit from WATC's experience as a major issuer in these markets.

Yours sincerely

JOHN COLLINS
CHIEF EXECUTIVE OFFICER
8 July 2013

TONY DIXON
CHIEF ADVISOR
8 July 2013

Response to the Secretariat's Working Paper (June 2013):
"On the benchmark cost of debt: Efficiency considerations"

Introduction

The Secretariat identifies the 'on-the-day' approach as being superior for the following reasons:

- It is the best predictor of the prevailing cost of debt and the cost of debt over the regulatory period;
- The base (swap) rate can be hedged such that the firm's cost of debt is close to the prevailing cost; and
- It performs best in ensuring that the right types and amount of investments are made (allocative and dynamic efficiency), and in providing incentives to deliver on those investments at least cost (productive efficiency).

The Secretariat also states that annual updates would be a further improvement, aligning closest with the cost of debt faced by all firms in the economy.

Response

Following the Stakeholder Workshop held on 3 July 2013, WATC offers the following comments.

1. With regard to the ability of entities to hedge large debt portfolios, Chairmont Consulting state in their report that the transaction costs of hedging with swaps are negligible. The report does not consider the impact on **the underlying swap rate** – and hence the effective overall cost of the hedge – when transacting large notional amounts or spreading the transactions across the regulatory reset window. As highlighted in WATC's March 2013 submission, the notional limit over a short period is approximately $1bn, beyond which the swap rate would begin to move appreciably. At some point the swap counterparties (banks) may struggle to hedge their exposure and may not wish to deal. It should be noted that market disruptions would make the situation worse.
2. The Secretariat's conclusions are based on the theoretical assumption that the firm's entire debt portfolio can be refinanced or hedged at the time of the regulatory reset. If this assumption does not hold, then these conclusions must be questioned.
3. For firms with large debt portfolios, it is not efficient to refinance or hedge all debt at one time every five years. Attempting to match the benchmark, in this case, would create greater financial risk and greater costs for these firms, which is not taken into consideration by the Secretariat . In effect, the overarching market funding and hedging constraints shifts the nature of efficient financing for these firms. For these firms, staggering debt across the maturity spectrum reduces rollover and repricing risk, and lowers the average cost of funding.
4. The rates in, for example, a 10-year 'debt ladder' are all 10-year rates, with each maturing line being refinanced at the prevailing 10-year rate. Although debt with higher interest rates may subsequently be refinanced at cheaper rates, the borrower is no better off as the future payment stream of the existing debt is 'marked-to-market', i.e., revalued/repriced at prevailing market rates. Indeed the borrower will be worse off as they will incur transaction costs.
5. If the benchmark cost of debt represents an efficient firm, then consideration should be given to making the benchmark scale-dependent, or allowing the regulated entities to have the opportunity to identify the most appropriate benchmark for them, be it 'on the day' or 'trailing average'. What may be 'efficient financing' for a small firm may not be 'efficient financing' for a large firm due to the inability of the market to absorb the larger firm's debt refinancing needs.

6. Concern was expressed that the 'trailing average' approach was simply 'cost pass-through' and offered "more than reasonable opportunity" to recover costs. However, one can consider the benchmark cost of debt to be a 'pass-through' of only efficient costs. Whether the benchmark uses an 'on the day' or 'trailing average' approach, only the efficient costs of financing are being passed through.
7. The suggested approach of resetting the cost of debt annually will exacerbate the refinancing and rollover risk of larger firms, as it will incentivise them to refinance or hedge their debt annually if they prefer match the benchmark.