QLD COMPETITION AUTHORITY

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Queensland Treasury and Trade

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15 APR 2013

Dr M Roberts
Chairman
Queensland Competition Authority
GPO Box 2257
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Dear Dr Roberts Malcolm

I am writing to you with comments from Queensland Treasury and Trade (QTT) on the Commission's Cost of Capital Methodology Review 2012-13.

QTT notes that there has been a broadly stable framework for estimating the cost of capital among Australian regulators in recent years. The risk free rate has been estimated based on current Commonwealth Government bond yields; the market risk premium on historical averages; and the term structure being either 5 or 10 years.

The Queensland Competition Authority (QCA)'s approach has followed the consensus for the risk free rate but adopted a basket method (of four methods, two current and two historical) for the market risk premium and a five year term as its benchmark.

While this framework seems to have worked effectively over several years, QTT considers that changes in economic and market conditions following the Global Financial Crisis have put stress on the approach. In particular, interest rate yields have fallen considerably, leading to weighted average cost of capital (WACC) estimates falling significantly.

The QCA WACC estimate for the 2010-13 regulatory period for water entities was 9.35 per cent (post tax nominal) but will fall to 6.57 per cent (post tax nominal) for the 2013-15 period under the current cost of capital methodology.

It is obvious that falls in the allowable WACC of such magnitude would have important implications for pricing and investment of regulated (or monitored) bodies and, these changes may be abrupt.

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QTT notes that other regulatory and rule-making bodies have also responded to current conditions with reviews. The Australian Energy Market Commission (AEMC 2012) amended National Electricity Rules to an approach that gives the Australian Energy Regulator (AER) the option of using a current or trailing average (or combination of both) to estimate the cost of debt. The method of calculation of the market risk premium is left open but 'regard must be had to the prevailing conditions in the market for equity funds'.

The Independent Pricing and Regulatory Tribunal (IPART)'s review of its cost of capital methodology is due to report in June 2013. The review's discussion paper indicates an openness to change, but a preference to retain a current approach to the risk free rate and an historical approach to the market risk premium.

In light of the above, QTT considers it appropriate to review the QCA's cost of capital methodology. QTT's comments are framed on these assumptions:

- The purpose of monopoly regulation is to promote economic efficiency – in pricing, operation and investment of the regulated bodies and, as a consequence the economic behaviour of customers and suppliers of the entities;
- The current economic and market conditions (and their consequences for regulated entities and customers) should be taken into account in regulatory decisions. The mechanistic use of a single approach to cost of capital estimates may no longer be appropriate;
- There is a balance to be struck between regulatory discretion and certainty. It may be appropriate to expand discretion; this should be on the basis of a clear regulatory framework that stakeholders can depend upon to have long term standing; and
- Any changes need to encompass balancing of all the interests – regulated entities, owners, customers and suppliers– and have internal rigour – and not simply be an opaque means of increasing regulatory WACCs.

On this basis, QTT considers that the QCA should give regard to these proposals for its cost of capital methodology:

- Report a range-estimate rather than a point estimate for the WACC but with a choice of a particular figure in the range as the QCA's central WACC estimate,
- Follow the AEMC approach to the cost of debt that is, specify that it will be based on current rates, historical averages (or a combination of both);
- Continue with its current approach to the market risk premium (that is, a basket of current and historical averages);
- Make clear that while a basket of estimates will be used, the weighting may vary substantially over time;
- Maintain CAPM as the primary model for cost of equity estimation but report results from other models;

- While employing a mix of estimation methods, provide certainty by setting out a clear objective that is, to promote economic efficiency – in pricing, operation and investment of the regulated entities and, as a consequence, the economic behaviour of customers and suppliers of these businesses. This objective can be supplemented by a financial principle that focusses on the efficient financing of an efficient enterprise; and
- Provide guidance before a regulatory period on any bias that will be employed in the estimation process. For example, whether the estimation process will be more forward looking (in periods when considerable investment may be required) or historical; and/or whether the upper or lower range of the estimates seems more suitable given economic conditions or industry considerations.

QTT considers that these changes - broadly greater regulatory discretion - but with an underpinning regulatory framework and strong communication with stakeholders– would be an effective response to the current conditions.

Should you require further information please contact Ms Tania Homan, Director, Microeconomics and Structural Reform on (07) 3035 1487 or tania.homan@treasury.qld.gov.au.

Yours sincerely

[redacted]

Helen Gluer
Under Treasurer