

Our ref: A2486305

John Hindmarsh
Chief Executive Officer
Queensland Competition Authority
Via email: water@qca.org.au

8 August 2014

Dear John,

Unitywater response to Weighted Average Cost of Capital (WACC) Position Paper

Thank you for the opportunity for Unitywater to provide input into the QCA's ongoing response to the Ministers' Direction Notice (the Direction) requiring the QCA to investigate and report on a long-term regulatory framework for the SEQ Distribution Retailers (DRs) and specifically the Position Paper titled Long-term framework for SEQ water retailers – weighted average cost of capital (WACC) (the Paper) that the QCA released on 1 September 2014.

Given the significance of the WACC to SEQ water retailers, Unitywater is concerned with the limited consultation time provided by the QCA (significantly less than two weeks for preparation of submissions) and notes that this has impacted on Unitywater's ability to adequately respond to the issues raised.

Unitywater is also concerned that while QCA can demonstrate that stakeholders have been consulted there appears to be little consideration of Unitywater's and other stakeholders (such as QTC and other SEQ water sector businesses) views. Unitywater and other key stakeholders have proposed views that are broadly consistent with precedent established by Australia's national regulator the ACCC and its' subsidiary energy regulator the AER that were formed subject to extensive consultation processes. It is disappointing that the QCA has instead adopted narrowly supported academic/technical arguments that are at odds with the QCA's stated aims of ensuring the adoption of pragmatic regulation for a sector that the QCA has repeatedly found has no evidence of monopoly pricing or misuse of monopoly power.

As per previous submissions regarding development of a SEQ water sector WACC, Unitywater seeks an outcome recognising the practical reality of the manner in which SEQ water businesses fund borrowings (an approach which is commonly adopted by commercial businesses and is considered to be the default efficient approach to debt funding) and the overarching concern of customers to avoid price volatility which is likely to be reinforced by the QCA's proposed WACC approach.

Unitywater therefore continues to support the use of:

- a. a trailing average approach to calculating the cost of debt rather than use of the rate of the day for cost of debt as the rate of the day approach will increase price volatility and ensure a disconnect between regulatory estimates of efficient pricing and pricing consistent with SEQ water entities actual efficient costs; and
- b. a 10 year commonwealth bond rate as proxy for the risk free rate rather than a one year risk free rate as recommended by the QCA as a one year rate risks under-estimating the cost of equity, is likely to be pro-cyclical and reinforce other cost pressures on customers and is likely to distort the structure of the CAPM as discussed by Queensland Treasury Corporation (QTC) in their submission to the QCA.

In this context, Unitywater notes that QTC are providing a submission in response to the Paper that will outline the technical concerns that it has with the QCA's proposed approach. Unitywater supports QTC's position in relation to the risks associated with the QCA's proposed approach and the view that a longer-term view should be adopted by the QCA in the setting of a WACC.

While QTC's submission will principally focus on the technical aspects of the Position Paper, we have some broader concerns that we feel need to be considered by the QCA. These broader issues include:

- a. The QCA has repeatedly acknowledged that there has been no misuse of market power and that as such there needs to be a pragmatic approach to regulation of the sector. In order to achieve a pragmatic outcome in the interests of all parties, it is critical that similar pragmatism is extended to setting the WACC. The Position Paper does not match the expected pragmatism that the QCA has indicated that it is trying to achieve.
- b. The application of a 1-year term to maturity ignores the fact that both pricing and investment decisions are made for the long-term. Unitywater does not agree with the proposed approach as it assumes that we re-set our business each year and completely disregard any future years from these decisions. This is counter to the long-term planning implicit with water and sewerage services and the need for capital investment decisions (and capital/operating cost trade-offs) to be made on a consistent basis.
- c. In our view, a regulator that is operating a light-handed framework should not prescribe a WACC to the regulated businesses for pricing purposes. While the QCA characterises its SEQ water sector WACC as a non-binding benchmark WACC, the approach that the QCA has adopted has, in essence, prescribed the approach for the businesses to use by having a prescriptive approach to the setting of a benchmark WACC that the businesses will be assessed by.

- d. The consequences of adopting a different WACC are unclear. If the adoption of a different methodology for setting a WACC results in a higher WACC than the benchmark WACC, but is an approach that is accepted by economic regulators as being a common approach to setting the WACC, what are the potential consequences for the businesses? The methodology should provide regulatory certainty and not impede entities future investment decisions.

The most important aspect of this submission is that where the businesses are responsible for setting prices, the QCA needs to be mindful of being too prescriptive in the setting of the WACC – thereby giving no alternative but to adopt a “QCA WACC” – as the QCA may inadvertently be seen as implicitly having a hand in the setting of prices within the light-handed framework. By setting a prescriptive approach and methodology whereby the onus will be on the businesses to justify any departure from the QCA’s benchmark approach, this in effect applies a prescriptive approach to the businesses.

Unitywater considers that ideally, under a light-handed framework, the QCA would nominate commonly accepted methodologies for determining the WACC with the decision on which approach left to the regulated business.

If you would like to discuss any of these matters further please do not hesitate to contact me.

Yours sincerely



Pauline Thomson
Chief Financial Officer

CC. George Theo, Chief Executive Officer, Unitywater

