

Our ref: A2070499

Dr Malcolm Roberts
Chairman
Queensland Competition Authority
GPO Box 2257
Brisbane QLD 4001

20 January 2014

Dear Dr Roberts

Unitywater's response to QCA's WACC report

Unitywater welcomes the opportunity to comment on the cost of capital related papers issued by the Queensland Competition Authority (QCA) in October and November 2013, namely:

- a. Response to Submissions on the Risk-free Rate and the Market Risk Premium (MRP);
- b. A Cost of Debt Estimation Methodology for Businesses Regulated by the Queensland Competition Authority;
- c. The Estimated Utilisation Rate for Imputation Credits; and
- d. Estimating Gamma.

Overall, Unitywater is keen to see the establishment of guidelines that set out the QCA's approach to calculating a Weighted Average Cost of Capital (WACC) and that the WACC calculated delivers sufficient returns to support prudent and efficient investment in water and sewerage infrastructure.

From Unitywater's perspective, one of the most important goals is to achieve greater regulatory certainty to enable the development of forward looking price paths to avoid customer price shocks as well as guiding participant's expectations. Since 2010 when the SEQ Water distributor-retailers became subject to economic regulation, the allowed rate of return has varied significantly:

	2010-11 to 2013-13	2013-14 to 2014-15	Movement
Cost of Debt	9.69%	6.49%	3.20%
Cost of Equity	8.85%	6.70%	2.15%
Nominal Post Tax	9.35%	6.57%	2.78%

Unitywater's view is that variability can be addressed through consideration by the QCA of methodologies for the calculation of the cost of debt and cost of equity that remove the impact of short term volatility whilst still aligned with economic theory.

Unitywater is keen to ensure that the regulatory process minimises the cost associated with the WACC debate and therefore proposes that, in the interest of Queensland consumers, the QCA should consider engaging with other regulators on this matter and consider the extensive range of already publically available papers on the topic.

Unitywater notes that the derivation of inputs to the WACC calculation is a complex and contentious matter which is evidenced by the variety of submissions made during the twelve month consultation period undertaken by the Australian Energy Regulator (AER) culminating in the release of their rate of return guidelines in December 2013. Through this review a large number of submissions were made to the AER of which nearly forty papers published were prepared by technical consultants.

In the interests of managing the cost to serve to our customers, Unitywater has elected not to engage technical consultants for any WACC debate but supports the following positions:

- a. Risk-free rate and MRP – Unitywater supports the use of a 10-year risk-free rate to calculate the cost of equity, and notes the practical considerations identified by Incenta Economic Consulting which also favour the use of a 10-year term.

Despite considering a range of MRP estimates, the QCA has consistently added a rounded MRP of 6 per cent to the prevailing risk-free rate to determine the expected return on the market portfolio. The resulting cost of equity estimates have been significantly more volatile than truly forward-looking estimates such as those produced by SFG's application of the Dividend Discount Model (DDM).

Unitywater supports a broad approach that does not result in the cost of equity moving point-for-point with changes in the risk-free rate. Such an approach would include SFG's DDM estimates and the long-term historical real return on the equity market (indexed by current expected inflation).

- b. Cost of Debt – Unitywater supports the use of a trailing average portfolio approach to calculate the cost of debt. The approach proposed by the Queensland Treasury Corporation (QTC), which involves a 10-year benchmark debt tenor, annual updates to the cost of debt, and the weight-averaging of new borrowings at the prevailing debt yield, is reflective of efficient debt financing practices. QTC's proposal is broadly consistent with the AER's new approach for calculating the cost of debt.

If you would like to discuss any of these matters further, please contact Pauline Thomson Unitywater's Chief Financial Officer on 07 5431 8259.

Yours sincerely



George Theo
Chief Executive Officer