

Date: 21 February 2011
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Location: Nerang
Phone: 5582 9046
Your Ref:
Our Ref: A-2010-1029

Mr EJ Hall
Chief Executive
Queensland Competition Authority
GPO Box 2257
Brisbane QLD 4001

Dear Mr Hall

Allconnex Water's comments on WACC component of the *SEQ Interim Price Monitoring for 2011/12 – Draft Report*

Allconnex Water appreciates the opportunity to provide comment to the Queensland Competition Authority (the Authority) regarding the weighted average cost of capital (WACC) component of the *SEQ Interim Price Monitoring for 2011/12 – Draft Report*.

The three south east Queensland distribution-retail authorities (Allconnex Water, Queensland Urban Utilities and Unity Water) jointly commissioned the Competition Economists Group (CEG) to provide a detailed response to the Authority's proposed WACC (Attachment 1 and associated companion reports).

In summary, Allconnex Water considers that:

- the Authority's equity beta estimate is very low relative to both market data and comparable regulated businesses. For example, recent decisions by the Independent Pricing and Regulatory Tribunal set the equity beta between 0.8 to 1.0 per cent.¹ Allconnex Water considers that an equity beta within this range is consistent with recent empirical evidence (see Chapter 6 of the attached CEG report) and should therefore be adopted by the Authority;
- the Authority adopted a maturity assumption for the risk free rate of three years - without any offsetting increase in the market risk premium. Allconnex Water considers that, consistent with the market risk premium, the term of the risk free rate should be set at 10 years (see section 3.1 of the attached CEG report); and

¹ See for example recent IPART decisions in relation to Country Energy and Gosford City Council and Wyong Shire Council.

- the Authority's analysis results in counterintuitive outcomes. In particular, the analysis results in a cost of debt that is significantly higher than the cost of equity. This result is inconsistent with accepted financial theory and suggests that the individual WACC parameters may not be appropriately specified. This issue is addressed further in section 6.8 of the attached CEG report.

Based on the above factors, Allconnex Water considers that the Authority's WACC estimate is too low and should be revisited.

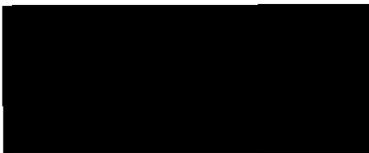
More generally, Allconnex Water is concerned with the very short timeframe provided to respond to the Draft Report. This concern is exacerbated by the Authority's proposal to set the WACC estimate for the three year interim period rather than the anticipated annual reset. While Allconnex Water has provided a considered response to the issues raised, in the interest of increased stakeholder involvement and improving regulatory outcomes, Allconnex Water suggests that the Authority allow for a more extended consultation process in the future.

Notwithstanding the above, Allconnex Water acknowledges the Authority's rationale for proposing to use the same WACC over the interim period, but is concerned that the proposed WACC may set a precedent for upcoming deterministic regulation. Allconnex Water expects that the development of a WACC estimate under future deterministic regulation will be the subject of an extensive consultation process. Accordingly, Allconnex Water wishes to clarify that the attached document represents an abbreviated response resulting from the condensed timeframe and does not limit Allconnex Water from revisiting WACC issues in detail at a future date.

In addition, Allconnex Water seeks clarification of the Authority's WACC estimate in the context of the Ministers' Direction Notice (the Notice). In particular, the Authority proposes a specific WACC value whereas paragraph (g) of the Notice indicates that the Authority shall "consider a WACC within a reasonable range of values for 2010-11" and will advise the entity of the "...WACC benchmark that it will consider in 2011-12 and 2012-13..."

If you require any further information regarding this response please do not hesitate to contact me on (07) 5582 8134 or email: andrew.foley@allconnex.com.au.

Yours faithfully



Kim Wood
Chief Executive Officer

Enc. Attachment 1