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Mr John Hall
Chief Executive Officer
Queensland Competition Authority
Brisbane QLD 4001

22 Feburary 2011

Dear ~~Mr Hall~~ John,

February 2011 Draft Report SEQ Interim Price Monitoring - WACC

Thank you for the opportunity to respond to the Queensland Competition Authority's[1] Draft Report titled "South-East Queensland Interim Price Monitoring for 2010/11 Part A Overview; Part B Detailed Assessment" and related appendices and consultant reports.

The subject of this response is the proposed Weighted Average Cost of Capital (WACC). Unitywater will make a further submission in response to other elements contained in the Authority's Draft Report on 28 February 2011.

Unitywater has used best endeavours to respond in a fulsome way to the Authority's draft report, albeit that the condensed timeframe for response has been challenging. Unitywater has therefore focused its response to critical matters and requests that the Authority consider not establishing precedent WACC parameters in the final report, for deterministic regulation commencing on 1 July 2013.

Unitywater agrees with several of the Authority's parameters and submits departures for a number of other parameters. To support its response, Unitywater, in conjuction with Queensland Urban Utilities and Allconnex Water, commissioned a joint consultancy to respond to the matters raised in the Authority's Draft Report and appendices. Attached to this letter and marked '**Appendix A**' are the expert opinions of Professor Grundy and Dr Hird of Competition Economics Group (CEG) in response to the Authority's Draft Report.

CEG has recommended a WACC of 10.81%. Unitywater endorses this WACC and its supporting justification and evidence.

Table 1 overleaf outlines the WACC parameters proposed by the Authority and the WACC parameters that Unitywater asks the Authority to consider, including comments on the reason for any differences between the two.

[1] Referred to as "the Authority" in this letter for enhanced readability.

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Table 1: WACC parameters

Parameter	Hird (CEG)	QCA	Comment
Gearing	60%	60%	N/A
Nominal risk free rate	5.45%	4.91%	CEG recommend use of ten year benchmark
Equity beta	1.00	0.66	CEG use updated estimates and correct the calculation error in Lally. CEG also give greater weight to Black CAPM.
Market risk premium	6.50% (7.04%)	6.00%	CEG 6.50% estimate is relative to the ten-year risk free rate. It has greater regard to forward looking estimates than the Authority estimate. CEG's 7.04% estimate is the estimate of MRP defined relative to a three-year risk free rate.
Nominal return on equity	11.95%	8.85%	Difference primarily reflects higher equity beta
Debt margin on ten year debt	4.48%	4.48%	NA
Cost of hedging to three year "regulatory period"	0.00%	-0.37%	CEG disagree with the Authority that its proposed hedging strategy is efficient or properly costed.
Debt refinancing allowance	0.125%	0.125%	NA
Cost of debt	10.06%	9.69%	Difference solely reflects disagreement on hedging strategy
Nominal vanilla WACC*	10.81%	9.35%	Yes

**The nominal vanilla WACC is an estimate of the required return on capital of investors after the cost of company tax has already been paid by the corporation.*

The four material differences between the Authority's Draft Report and the Unitywater response relate to:

1 **A higher equity beta estimate.** CEG's 1.0 estimate of beta adds 2.86% to the cost of equity estimate (given 6.50% MRP) compared to using the 0.66 beta adopted by the Authority.

2 **The selection of a risk free rate to be used in the CAPM**. The use of the ten-year CGS yield adds 0.54% to CEG's estimate of the cost of equity compared to the Authority's use of the three-year CGS yield.[2]

Unitywater notes that correspondence from the Authority, arising from the first State interest review of draft Priority Infrastructure Plans for Water and Sewerage, indicates a WACC schedule adopting a risk free rate based on 10 year CGS yields. The Authority acknowledged that this was consistent with the view articulated in LG Bulletin 06/01.

Unitywater contends that there appears to be an inconsistency in approach from the Authority which may affect consistent application of pricing principles for developers contribution revenue and service tariffs.

3 **A higher MRP estimate**. The adoption of an MRP of 6.50% (compared to 6.0%) adds 0.33 to the cost of equity at the Authority's equity beta of 0.66.

4 **The assumed debt hedging strategy for the businesses.** CEG do not assume any net costs are able to be saved by adopting a debt hedging strategy whereby businesses attempt to create exposure to three year risk free rates. The Authority assumes that such a strategy will lower the cost of debt by 0.37%.[3]

Unitywater would welcome any supplementary opportunity to further discuss this submission in determining a reasonable range of values for the WACC to apply in interim price monitoring period. Any technical queries relating to this matter can be directed to Unitywater's Manager of Regulatory Affairs, Damian Platts, on (07) 5431 8235.

Yours sincerely

[redacted]

Jonathan P.C. Black
Chief Executive Officer

CC: Antoinette Carley, General Counsel
Pauline Thomson, Chief Financial Officer

Attachments:

1. Appendix A – WACC Estimation A report for South East Queensland water businesses;
2. The Calculation of the Cost of Capital A Report for South East Queensland Water Businesses; and
3. Determination of the WACC in the Setting of a 5 year Regulatory Cycle

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2 This assumes that no adjustment is made to the MRP estimate for the fact that it is measured relative to lower risk free rate proxy. This is consistent with the actual practice of the Authority.

3 This is the difference between 10 and 3 year risk free rates (54bp) less the Authority's estimate of the transaction costs of that hedging strategy (17.4bp).