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29 January 2021

Mr Charles Millsteed
Chief Executive Officer
Queensland Competition Authority
GPO Box 2257
Brisbane QLD 4001
(https://www.qca.org.au/submissions)

Dear Mr Charles Millsteed

Requests for Comments Paper (November 2020): Rate of Return Review

Urban Utilities welcomes the opportunity to provide comment on the Queensland Competition Authority ("QCA") November 2020 'Rate of Return Review' paper ("the RoR Review"). Urban Utilities appreciates the preliminary work QCA has provided to help inform stakeholder views on these matters and acknowledges the importance of these issues that impact on the approach to determining rates of return for regulated businesses.

Set out below are Urban Utilities general views of the weighted average cost of capital ("WACC") methodology on which the QCA are seeking stakeholder feedback:

1) **Cost of debt** – Urban Utilities support the trailing average approach involving a 10-year tenor to calculate the risk-free rate rather than an 'on-the-day' approach to refinancing debt based on:

   a) consistency with the debt management strategy used in practice by many utilities, including Urban Utilities, to manage its interest rate exposure;

   b) produces a relatively stable cost of debt estimate thereby reducing annual variability in the WACC and thus the maximum allowable revenue recoverable through utility charges; and

   c) consistency with observed approach adopted by other Australian regulators.

2) **Cost of equity** – In determining a reasonable return on equity, Urban Utilities are supportive of an approach that does not adversely affect investment leading to inadequate capacity and/or service quality and potentially reduce revenues to the point where the financial sustainability of the regulated entity is undermined.

   The asset beta, equity beta and gearing used by Urban Utilities have been consistent with the historical parameters used by the QCA. Notwithstanding, Urban Utilities are open to further discussion on the parameters and methodology used for estimating the cost of equity and would be interested in any technical comments submitted by Queensland Treasury Corporation ("QTC") as part of this consultation process.

Further input and comments on respective RoR Review questions are provided in Appendix A for QCA consideration.

Should you have any queries in relation to our submission please contact James Benjamin, Head of Strategic Finance on 3855 6161 or James.Benjamin@urbanutilities.com.au.

Yours sincerely

Ruth Coulson
Chief Financial Officer
URBAN UTILITIES

Cc. Mr Russell Silver-Thomas, Queensland Competition Authority
Enc. Appendix A: Urban Utilities comment on RoR Review questions

Appendix A – Urban Utilities response to RoR Review questions

Ref	RoR Review Question	Urban Utilities Response
Gearing		
Q1	Should the relevant comparators for determining the benchmark gearing of a regulated firm be those used in our beta analysis?	It would be preferable that these be the same/similar to ensure better alignment to the actual firm/s gearing and risk profile. This will ensure balanced unbiased outcomes without the need to undertake various adjustments if the two are different.
Cost of debt		
Q2	Should the trailing average be applied to the entire benchmark cost of debt, or only to the debt risk premium?	The total cost of debt benchmark should reflect the trailing average approach. When debt is refinanced the Debt Risk Premium ("DRP") forms part of the new cost as well as the Risk-Free Rate ("RFR").
Q3	What should be the term of the trailing average cost of debt, and how frequently should each debt tranche be refinanced?	It is preferable that the term of the trailing average cost of debt be 10 years. The frequency of the refinancing to be annually at a minimum with the option of more frequent refinancing to assist in reducing repricing and refinancing risk. With the maximum frequency for refinancing being quarterly. The refinancing frequency is not a comment on the frequency of price setting.
Q4	Should each debt tranche in the trailing average cost of debt be given equal weighting, or should some alternative weighting scheme (such as weighting by capital expenditure) be implemented?	Each year should be given equal weight to allow for a smoothed outcome to WACC changes which would translate to smooth pricing changes (if required). Additionally, this would remove complexity of applying the trailing average.
Q5	Should the price changes for a trailing average cost of debt be passed through each year, or at the end of each regulatory period?	Price changes for the trailing average cost of debt should be passed on annually to smooth any potential price shocks due to the build-up of cost of debt changes that have not been set into the price.
Q6	Should there be a transition period to a trailing average cost of debt, or should the trailing average be implemented immediately? If there is a transition, what should it look like—for example, how long should the transition be?	There should be flexibility in this approach as it would be dependent on the way the entity manages it debt refinancing profile. An entity that currently manages refinancing and pricing risks through annual refinancing of a portion of its debt should be able to replicate its debt management strategy into the WACC calculation. Whereas an entity that has managed refinancing in-line with regulatory price setting should be able to transition into the trailing average.
Q7	Should a regulated entity commit to a trailing average approach for a minimum length of time (for example, 10 years)?	An entity should commit to at-least a 10-year period of the trailing average approach. This duration will reduce suboptimal customer outcomes if markets change in an adverse manner and entities pass this onto customers through higher prices and higher returns to equity providers.
Q8	Should the relevant comparators for assessing the credit rating of the regulated firm be those used in our beta analysis?	Most regulated entities are rated in the BBB credit rating band, as such the assumed credit rating for WACC purposes should remain in the BBB credit rating band. Secondly, the data for DRP for BBB credit profile entities is more balanced when compared to the A rating band, which is heavily weighted to the A- end. The distortion in the weighting of the A band and could distort DRP applied to A rated entities, i.e. a higher DRP could be applied.

Ref	RoR Review Question	Urban Utilities Response
Q9	Should we continue to use data from third-party providers to calculate the cost of debt? If so, which third parties? What approach should be used to derive the cost of debt estimate (i.e. average of multiple third-party sources)?	It is recommended that an open source of data be used to allow for transparency. Based on this the RBA should be used as the preferred data source. If the RBA data is unavailable a backup data source should be nominated (Bloomberg is recommended due to its broader use). The backup source should be utilised until the RBA data is available.
Q10	For the on-the-day cost of debt calculation: • What is an appropriate length averaging period? • When should the averaging period be, relative to the commencement of the regulatory period? For example, should the averaging period occur no more than six months before the regulatory period commences?	Urban Utilities is not supportive of an on the day approach, instead we recommend that an annual average is taken to ensure the perception of price setting is preserved. The observation period should conclude within six months of the regulatory period to ensure a nexus between the observations and pricing.
Q11	For the trailing average cost of debt calculation: • What is an appropriate length averaging period? • When should the averaging period be? Should the averaging period occur at the same time each year?	The averaging period should be the whole year. The annual average period needs to conclude prior to the commencement of the relevant price setting year and remain consistent for as long as the trailing average method is utilised.
Q12	Are there other cost categories we should consider in estimating a debt raising cost allowance? Are different debt raising costs required dependent on the debt management strategy adopted?	Debt raising costs is a generic cost recovery allocation that allows for most costs associated with debt raising to be recovered. No further allowances need to be considered e.g. legal costs, as this should be covered in the debt raising costs. The allowance could be different for different debt management strategies adopted if it can be demonstrated that the different strategy was required and was deemed to be prudent.
Q13	Are there any other matters relating to the implementation of a trailing average cost of debt that we should consider?	The transition to the trailing average cost of debt. Further consultation on specific alternative approaches may be warranted.
Cost of equity		
Q14	Over what time horizon should we estimate beta (e.g. 2 years, 5 years, 10 years)?	The longer the time horizon the better the reflection of the investment in long term assets by equity investors. Debt funding has specific tenors whereas equity in regulated assets tends to be longer than debt.
Q15	What return interval(s) should we rely upon when estimating beta (i.e. should our asset betas be estimated using daily, weekly, or monthly return data)?	Urban Utilities welcomes any technical comments from Queensland Treasury Corporation to help inform our view on this matter.
Q16	Given that some volatility in beta estimates will reflect statistical noise, should we consider maintaining the beta estimates of our industry reference points for set period of time (for example two years) unless there is compelling evidence to change those estimates?	This would depend on the observation period as to the significance of the statistical noise. It would be preferable to look through this noise.
Q17	Are the following features appropriate for assessing the level of risk that a firm is exposed to? If so, are they equally important or are some factors more important than others for assessing the risk of a firm? • Market power • Nature of the customer base • Regulation • Contracting arrangements • Elasticity of demand for the product/service • Growth options	Urban Utilities welcomes any technical comments from Queensland Treasury Corporation to help inform our view on these matters.

Ref	RoR Review Question	Urban Utilities Response
	• Operating leverage	
Q18	How important are the physical and operational characteristics of the regulated entity when evaluating the relevance of comparator firms and industries?	
Q19	In recent reviews we have considered firms operating in regulated energy and water, toll roads, pipelines and Class 1 railroads industries as beta reference points. Are there any other industries that could act as useful reference points to determine beta for the entities that we regulate?	
Q20	What characteristics of a firm are likely to make it unrepresentative of a typical firm operating in that industry (e.g. having operations in other industries; having parent ownership; the regulatory framework being too dissimilar; and being in a country outside of Australia or in a less-developed country)?	
Q21	What other criteria should we consider when identifying comparator firms in our sample industries (e.g. sufficient trading volume, market capitalisation and standard errors of beta estimates)?	
Q22	Should we continue to rely on the results from each of the Ibbotson, Siegel, Wright, Cornell dividend growth model and survey methods? Should we place relatively more weight on historical methods or forward-looking approaches?	
Q23	Should we continue to assess a value for the MRP based on the median, mean and a weighted mean of the estimates produced by each method?	Anecdotal evidence seems to indicate that the Market Risk Premium ("MRP") is not static but has a negative correlation to the RFR. Urban Utilities would be interested in exploring the option to adjust the MRP to counter the movement in RFR.
Q24	As part of the historical estimation methods, should we continue to compute historical returns using an arithmetic average, or should we also use a geometric average?	Geometric average should be considered as it takes into consideration the compounding between periods. It is understood that equity investors tend to utilise geometric average rather than arithmetic average.
Q25	As part of our historical methods should we continue to give primary weight to the sampling period from 1958–present, or should we give more weight to a different sampling period/s?	1958 to present is preferred as this covers a relevant period in terms of potential future financial performance. Also, this length of time will reduce volatility caused by short term factors.
Q26	Should we allow for the risk-free rate to be calculated over a longer averaging period than 20 days?	The averaging period should be the whole year. The annual average period needs to conclude prior to the commencement of the relevant price setting year and remain consistent for as long as the trailing average method is utilised.
Q27	Should we broaden our estimate of the distribution rate to give weight to rates based on unlisted equity? Should we estimate the utilisation rate using alternative approaches such as taxation statistics or market value studies (i.e. dividend drop-off)?	Due to Urban Utilities ownership structure, imputation credits are not considered and as such we have not had the requirement to form a view on this matter.