29 January 2021

Mr Charles Millsteed
Chief Executive Officer
Queensland Competition Authority
GPO Box 2257
Brisbane QLD 4001

Transmission via: www.qca.org.au/submissions

Dear Mr Millsteed

The Gladstone Area Water Board (GAWB) appreciates the opportunity to comment on the Queensland Competition Authority's (QCA) 2021 Rate of Return consultation paper.

GAWB is supportive of this review given the material nature of the issue for both regulated businesses (i.e. for the purpose of investment signals, financial viability) and customer prices. This review is timely as there have been some significant changes to the QCA's historical approach[1] and it has been some time since the QCA's methodological approach was considered holistically rather than in the context of periodic regulatory assessments.

Consistency or procedural certainty is important for both regulated businesses, investors and customers when it comes to the material components of the regulatory process. As such, it may be desirable to adopt a similar approach to the Australian Energy Regulator (AER) where parameters or the methodology for estimating the rate of return are defined up front rather than being up for calculation/debate at each regulatory review. However, given the potential for unforeseen events and breadth of regulatory assessments conducted by the QCA (e.g. the industries subject to economic regulation and different regulatory approaches with an industry), flexibility should be provided for deviations from the agreed framework if a valid case can be made.

Several jurisdictional and industry regulators have, or are currently, undertaking similar reviews. What is evident from these investigations is that matters, such as the treatment of inflation, are having a material impact on the financial viability of regulated businesses. It is noted the treatment of inflation is not currently within the remit of this review and GAWB is comfortable with this position at this point in time. However, if there were to be a broadening of the QCA's scope to include such issues, there should be a commensurate reassessment of the project timeframe in recognition of the complexity of the matters for consideration.

GAWB's comments on the Consultation Paper, as set out below, focus on the cost of debt, beta and market risk premium (MRP) parameters and are reflective of the positions stated in our regulatory proposal (and supporting documentation) for the 2020-25 regulatory period.

[1] For example, the methodology used to determine the estimated risk-free rate.

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Question 1: Should the relevant comparators for determining the benchmark gearing of a regulated firm be those used in our beta analysis?

The relevant comparators for benchmark gearing and beta analysis do not need to be the same. For gearing purposes, it is sufficient to focus solely on water utilities. While the mining and industrial services companies supplied by GAWB, are relevant for establishing GAWB's exposure to systematic risk, they are less relevant for establishing an appropriate gearing ratio. This is due to water utilities having different investment requirements owing to their substantial infrastructure component.

Question 5: Should the price changes for a trailing average cost of debt be passed through each year. or at the end of each regulatory period?

As noted by the QCA, year to year changes in the cost of debt will need to flow through to the setting of prices. This presents a challenge for GAWB's current regulatory framework, including creating some price uncertainty for our customers.

Currently, prices are set at the start of each regulatory period and contractually can only be increased by the consumer price index (CPI) within-period. If prices are to be adjusted during the regulatory period, beyond these CPI changes, it will add an additional layer of uncertainty for customers as a revenue 'true up' would need to occur at the start of each regulatory period.

The approach ultimately adopted by the QCA, must provide regulated businesses with the ability to implement alternative arrangements, provided they appropriately balance the businesses' commercial obligations and the resultant pricing impacts for customers.

Question 6: Should there be a transitional 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?

The need for a transitional period should be assessed by the QCA on a case-by-case basis in consultation with the regulated business. As additional time may be required to allow the regulated business to adjust its current financing arrangements.

Question 9: 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)?

GAWB holds the view that the use of independent third-party data sources that are reputable and robust is appropriate for calculating the cost of debt.

Question 17: 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***
- ***Operating leverage***

The key objective of the first principles analysis is to assess the extent to which the firm's net cash flows (revenues less costs) have some sensitivity to movements in the general economy. A number of the factors listed are interrelated. That is, the impact of one factor on beta could either be increased or lessoned by another factor. Hence, while the impact of each factor can be considered in isolation, the assessment should also consider the net impact of the collective factors.

Question 18: How important are the physical and operational characteristics of the regulated entity when evaluating the relevance of comparator firms and industries

Question 19: 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?

Whilst listed water utilities represent a natural starting point for sourcing comparators, it is important that due consideration is also given to the physical and operational characteristics of the regulated entity. As noted in GAWB's regulatory submission (September 2019), the activities undertaken by the regulated business's customers can impact its exposure to risk.

As GAWB's main customers are involved in activities linked to the mining and resources processing sectors, the beta estimates used in the recent bottom-up assessment, included relevant companies that operate in the mining and industrial services sectors.

In effect, the composition of our customer base imparts aspects of a mining or industrial services company's risk profile. We are not proposing that full weight be applied to these kinds of firms. Rather that their inclusion allows for a suitable range to be established; from which, a point estimate can be identified (as informed by the subsequent first principles analysis).

Question 22: 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?

More weight should be given to the Wright MRP methodology when interest rates are well below their long-term averages, as is now the case. Increasing the weight assigned to the Wright MRP would involve offsetting decreases to other methodologies that compromise the QCA's current approach, such as the relatively high weight assigned to the Ibbotson and Siegal MRPs.

The QCA should also consider revising the growth assumptions underpinning its Cornell DGM estimates, which are not delivering outcomes consistent with market dynamics or other indicative regulatory estimates.

If you have any questions in relation the matters raised above, please do not hesitate to contact Angela Moody (Regulation and Planning Manager) on 07 3020 8014 or myself on 3020 8015.

Yours Sincerely

Hugh Barbour
Chief Financial Officer
Gladstone Area Water Board