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

10 October 2014

Dear Malcolm

Unitywater's response to QCA's Trailing Average Cost of Debt

Unitywater welcomes the opportunity to comment on the Trailing Average Cost of Debt Paper released by the Queensland Competition Authority (QCA) on 29 August 2014.

As previously indicated, 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) consistent with ensuring sufficient returns to support prudent and efficient investment in water and sewerage infrastructure and reflecting pragmatic recognition of the council owned nature of the distribution/retail water businesses in SEQ and their common reliance on the Queensland Treasury Corporation (QTC) to organise efficient debt financing for the businesses.

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 that avoid customer price shocks whilst guiding participant's expectations.

For every $100 received from a customer around $20 now goes towards recovering the cost of debt, therefore there is a high incentive to manage this cost and it's variability.

As set out in our previous submissions, Unitywater's view is that the variability in the cost of debt can be addressed through the adoption of the trailing average approach which represents both a practical and efficient way in which to manage this key cost and is consistent with the approach adopted by the national energy regulator (the AER) and is the approach recommended by QTC at the end of 2012-13 when Unitywater's funding arrangements became due for renewal.

At this time, in the absence of clarity over the future form of regulation for SEQ water distributor-retailers, Unitywater sought advice on an efficient debt financing and risk management strategy in order to minimise costs and the impact of large movements in interest rates, and to maintain an acceptable level of refinancing risk.

Unitywater is a statutory authority that provides water and sewerage services for the Moreton Bay, Sunshine Coast and Noosa Council areas.

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QTC as the state's primary treasury manager and responsible for providing financial advice and risk management services, sourcing and managing debt funding for infrastructure and investing cash surpluses for Queensland's public sector organisations was considered the most appropriate authority from which to obtain such advice.

QTC's advice was to establish a portfolio of fixed rate debt with staggered maturities out to approximately ten-years with the portfolio cost of debt updated each year to reflect the interest rates on refinancing and new borrowing transactions performed during the year. This approach was also broadly consistent with the regulatory precedent set by the AER and IPART in their decisions on setting the regulatory cost of debt

Unitywater is therefore deeply concerned that the QCA would consider not accepting a method proposed by the Queensland Government's appointed authority on debt management. Further, it is of concern that that the QCA's position would be formed seemingly based on a single New Zealand academic's opinion while rejecting QTC's well-argued position and clear regulatory precedent. Further, this seems at odds with the QCA's stated position outlined in multiple discussions with Unitywater that given the lack of evidence of any misuse of market power, the QCA would seek to adopt a light handed and pragmatic approach to oversight of the water businesses.

Unitywater therefore reiterates support for the use of a trailing average approach (which applies to the total cost of debt) to calculate the regulated cost of debt.

In particular Unitywater supports the following comments by QTC that the trailing average approach (as described by QTC) to be a significant improvement on the 'on the day' approach on the basis that:

a. It represents more efficient debt financing practices;
b. Will reduce mismatches between regulatory allowances and efficiently incurred debt costs;
c. Will produce a relatively stable interest cost over the long-term, which is considered appropriate for firms with relatively stable revenues that are not overly sensitive to the economic cycle;
d. Retaining the 'on the day' approach or only applying the trailing average to the debt risk premium would incorrectly imply that efficient debt management practices are determined by arbitrary factors such as the term of the regulatory period which may not be relevant to SEQ water distributor-retailers under the long term regulatory framework under development by the Authority;
e. As concluded by the Australian Energy Regulator (AER), a trailing average approach that applies to total 10 year cost of debt is more reflective of the actual debt management approaches of businesses operating in a competitive market and, therefore, more likely to represent efficient financing practice;
f. In the absence of regulation, it is unlikely that an efficiently financed business would use an interest rate swap to fully reset the base interest rate on its entire debt portfolio once every 5 years, or any other frequency; and

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g. There are practical ways to implement a weighted trailing average, which will reduce the potential for investment distortions by compensating new borrowings at the prevailing cost of debt.

If you would like to discuss any of these matters further please do not hesitate to contact me.

Yours sincerely

Pauline Thomson
Chief Financial Officer

Cc: George Theo, Chief Executive Officer, Unitywater

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