QUEENSLAND UrbanUtilities

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21 February 2011

Mr E J Hall
Chief Executive Officer
Queensland Competition Authority
GPO Box 2257
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Dear Mr Hall

Submission to the Queensland Competition Authority - Draft SEQ Interim Price Monitoring Report Appendix B: Weighted Average Cost of Capital

This submission is the Queensland Urban Utilities (QUU) response to the weighted average cost of capital (WACC) as outlined in the Queensland Competition Authority's (the Authority) Draft Report SEQ Interim Price Monitoring for 2010/11, Part B – Detailed Assessment February 2011 Appendix B: Weighted Cost of Capital (the Report).

Our submission includes the initial general comments below, comments on parameters and the response to the Report prepared by Competition Economics Group (CEG) on behalf of the three distributor-retailers.

General Comments

Response Timeframe

The extremely short timeframe of nine working days allowed by the Authority to respond to the proposed WACC in the Report is very concerning. The short consultation period not only affects the distributor-retailers but also the public who will have had limited time to prepare a submission. The lack of time was further compounded by information on which Dr Lally's (the Authority's consultant) report relied, being unavailable until the commencement of the second week.

This length of time provided for a response on such a complex issue does not in our view represent true consultation and QUU seeks a commitment from the QCA that adequate timeframes are provided in the future for the remainder of price monitoring term and in preparation for deterministic regulation.

CEG has raised a range of issues that the Authority will need to address before issuing the final report. QUU was not expecting, given the wording of the Direction, that the benchmark WACC would be set for the three year term of the price monitoring period.

Given that the Authority intends to set the WACC for three years, we ask that the issues raised by CEG not be dismissed on the grounds of insufficient time for consideration. Currently QUU as an organisation has a significant commitment to recover assets damaged by the floods in Brisbane, Ipswich, Lockyer Valley and Somerset to normal operation.

This together with the short timeframe allowed has meant while QUU is providing a response we have not been in a position to consult fully with all parties, including with our Board, which we consider necessary to provide a considered response on all issues. Accordingly QUU reserves the right to make a further submission following consultation with our Board.

QUU wants to make it clear that comments in relation to certain parameters and the underlying estimation methodology for the price monitoring period should not be interpreted as the QUU view of the WACC that should apply for the deterministic price period from 1 July 2013.

Cost of Debt exceeding Cost of Equity

The proposed WACC shows an imbalanced view between debt, which is estimated on recent data and equity, which takes little account of recent data. The result is a cost of debt above the cost of equity which is not surprising given the very low cost of equity. This outcome seems to ignore recognised financial theory that the cost of equity should be higher than the cost of debt however no commentary on the rationale for this outcome is included in the Report. We concur with the CEG view that:-

- the cost of debt estimate is within a reasonable range; and
- the cost of equity estimate is unreasonably low (the cost of equity estimate is lower than the cost of debt which is inconsistent with well accepted foundations of finance theory).

This imbalance also impacts directly on the tax calculation included in the maximum allowable revenue (MAR). Indeed when using the proposed WACC the return on capital (net of indexation) after allowing for the interest to be paid to debt holders and non cash donated assets shows no return available to the equity holders.

Ministerial Direction

The proposed WACC is a point estimate which is contrary to the Direction, which required the Authority to:

"(g) consider a weighted average cost of capital (WACC) within a reasonable range of values for 2010/11.

Given the particularly low proposed cost of equity the point estimate has to be considered to be at the very low end of a range. The Report does not make any comment on the reasonableness of the MAR derived using WACC within a reasonable range when compared to forecast revenue.

The original report commissioned by the three distributor-retailers from CEG provided a range for WACC. Given the timeframe in which the distributor-retailers had to determine the pricing for the 2010/11 year and the possible WACC parameter selections we believe a WACC range to be more appropriate. We ask that the Authority consider WACC within a reasonable range and provide the corresponding reasonable range for MAR.

Parameters

The CEG report includes the proposed parameters as extracted in the table below. Together with the comments above QUU supports the approach adopted by CEG.

CEG WACC parameters

Parameter	CEG	QCA	Mechanistic reason
Gearing	60%	60%	N/A
Nominal risk free rate	5.45%	4.91%	CEG recommends use of 10 year benchmark
Equity beta	1.00	0.66	CEG uses updated estimates and corrects calculation error by Dr Lally. CEG also gives greater weight to Black CAPM.
Market risk premium	6.50% (7.04%)	6.00%	CEG's 6.50% estimate is relative to the 10 year risk free rate. It has greater regard to forward looking estimates than the QCA estimate. CEG's 7.04% estimate is the estimate of MRP defined relative to a 3 year risk free rate.
Nominal return on equity	**11.95%**	**8.85%**	**Difference primarily reflects higher equity beta**
Debt margin on 10 year debt	4.48%	4.48%	NA
Cost of hedging to 3 year "regulatory period"	0.00%	-0.37%	CEG disagrees with QCA 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%**	

Source: Bloomberg, CBASpectrum, RBA and CEG analysis.
**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.*

More detailed discussion on the parameters is outlined in the attached response from CEG.

In summary QUU's position is that the cost of debt is within a reasonable range and the cost of equity is unreasonably low.

Thank you for the opportunity to comment.

Yours sincerely

[redacted]

NOEL K FAULKNER
Chief Executive Officer
Queensland Urban Utilities

Cc: Mr Rick Stankiewicz, Queensland Competition Authority