Redland
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27 January 2021

Mr Charles Millsteed

Chief Executive Officer

Queensland Competition Authority GPO Box 2257

Brisbane QLD 4001

Dear Mr Charles Millsteed

Requests for Comments Paper (November 2020): Rate of return review

Redland City Council (RCC) welcome the opportunity to provide comment on the Queensland Competition Authority ("QCA") November 2020 'Rate of Return review'.

Set out below are the broad views of RCC regarding the QCA proposed rate of return methodology:

1) Cost of debt - RCC supports the wider view of the QTC and SEQ water service providers. Namely, using the trailing average approach involving a 10-year tenor to calculate cost of debt rather than 'on-the-day' approach. RCC's determination is premised on the followings:

   i. it produces a relatively stable cost of debt estimate thereby reducing annual variability in the WACC, thus the maximum allowable revenue recoverable through utility charges;

   ii. it reflects the cost of debt produced by a prudent and efficient benchmark debt strategy that is appropriate for a highly geared natural monopoly business which provides an essential service in a capital intensive industry; and

   iii. it is consistent with observed approach adopted by other Australian regulators. For example, the AER, ESC, ESCOSA and ICRC all have recently used a trailing average cost of debt approach.

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'The AER proposes to estimate the allowed return on debt using a trailing average portfolio approach following the completion of a transitional arrangement period. In particular, the AER proposes to apply the following:

- *a trailing average portfolio approach with the length of the trailing average to be 10 years*
- *equal weights to be applied to all the elements of the trailing average*
- *the trailing average to be automatically updated every regulatory year within the regulatory control period.'*

Source: Australian Energy Regulator (AER), December 2013, Better Regulation Rate of Return Guideline P.19

2) Cost of equity – RCC's view is that the approach taken in determining a reasonable return on equity should 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 endangered.

RCC is open to further discussions on the parameters used for calculation of cost of debt and cost of equity, and welcome any technical comments from QCA and QLD Treasury Corporation (QTC).

The detailed commentary for the rate of return review questions are provided in Appendix A.

Should you have any queries in relation to our submission please contact Julia Dyer, Senior Financial Modeller on 07 3829 8948.

Yours sincerely,

Michael Wilson

Service Manager Financial Planning

Redland City Council

Enc. Appendix A· RCC comments on Rate of Return review questions

Appendix A: RCC comments on Rate of Return review questions

Ref	QCA question	RCC comment
Q1	Should the relevant comparators for determining the benchmark gearing of a regulated firm be those used in our beta analysis?	AASB16 Leases impact (increasing EBITDA, but reducing pre-tax profit, and an increase in Debt to Equity ratio and a reduction in interest cover ratio) will need to be considered.
Q2	Should the trailing average be applied to the entire benchmark cost of debt, or only to the debt risk premium?	The trailing average should be calculated using the total cost of debt, rather than the debt risk premium (DRP) only. Australian Energy Regulator (AER 2013) supported a TA approach that applies to the total 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 practices Queensland Urban Utilities (QUU 2014), UnityWater (UW 2014), and Queensland Treasury Corporation (QTC 2014). All three submissions supported the adoption of a TA approach applied to the total cost of debt. ("SEQ Retail Water Long-Term Regulatory Framework - weighted average cost of capital (WACC) September 2014 final report Page 28-29")
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 should be 10 years.
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).	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). Australian Energy Regulator (AER), December 2013, Better Regulation Rate of Return Guideline P.19 o a trailing average portfolio approach with the length of the trailing average to be 10 years o equal weights to be applied to all the elements of the trailing average o the trailing average to be automatically updated every regulatory year within the regulatory control period
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?	If it is passed through annually, timing and resources need to be considered. However it may create higher uncertainty year on year on utility price. If not, and it is passed through at the end of each regulatory period, the time value of money need to be considered. IPART (2018) – "Where we decide to use a true-up, we will discount changes in the cost of debt by the WACC to account for the time value of money."
Q7	Should a regulated entity commit to a trailing average approach for a minimum length of time (for example, 10 years)?	It is preferable that the term of the trailing average cost of debt should be 10 years

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. RBA estimates are unbiased and appropriate for the purposes of calculating a benchmark cost of debt. The RBA's estimation method is fully disclosed and the swap spread estimates are publicly available on the RBA website at no cost. In the event that the RBA data is not available a backup data source should be nominated.
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?	It is preferable to use one year average period as close as reasonably practical to the beginning of the forthcoming pricing setting period, in order to reduce interest rate risk arising from a shorter period and smooth out possible anomalies.
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 e.g legal cost, agency fee. No further allowances need to be considered unless it is identified and deemed to be required and prudent in the organisation debt management strategies.
Q13	Are there any other matters relating to the implementation of a trailing average cost of debt that we should consider?	The matters relating to the transition in the trailing average cost of debt will need to be considered
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?	RCC supports QTC view of where low/falling risk-free rates are usually accompanied by an increase in MRP required by investors (QTC May 2016 review - Redland City Council 2016 WACC - Water Business). RCC is interested in exploring the option to adjust the MRP to counter the movement in RFR. RCC also supports QTC's view on an unrounded simple average of the outputs, while the QCA's current practice is to round the MRP estimate to the nearest half percent

RCC welcomes and appreciates QCA/QTC's view on the technical components.