QLD COMPETITION AUTHORITY

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QUEENSLAND UrbanUtilities

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28 March 2013

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

Dear Dr Roberts

Submission to the Queensland Competition Authority's industry-wide cost of capital methodology review

Thank you for the opportunity to provide a response to the following discussion papers published by the Queensland Competition Authority (the Authority):

- Risk and the Form of Regulation; and
- The Risk-free Rate and the Market Risk Premium

Queensland Urban Utilities' response is provided as an attachment to this letter. The response is a combined response to the two discussion papers and is replicated in Unitywater's response to the discussion papers.

The methodology used in calculating the cost of capital can have a significant bearing on the estimate and therefore the subsequent revenue/prices. Therefore it is important to ensure that the most appropriate methodology is applied to ensure that both businesses and customers are not being unfairly disadvantaged.

Queensland Urban Utilities looks forward to engaging with the Authority during its review process. If you have any queries in relation to our response, please contact Tim Ryan, Manager Regulatory Affairs on (07) 3178 5082.

Yours sincerely

[redacted]

ROBIN LEWIS
Acting Chief Executive Officer
Queensland Urban Utilities

Enc.

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Attachment A

SEQ Distributor Retailers' response to the QCA's WACC Discussion Papers

Queensland Urban Utilities and Unitywater (the DRs), welcome the opportunity to provide this first joint submission to the QCA's 2012-13 cost of capital methodology review. While the DRs are not currently subject to deterministic price regulation under the QCA Act, the regulatory cost of capital still has a large impact on our operations under the existing price monitoring arrangements.

We also consider that a stable benchmark cost of capital will be a critical element of the permanent price monitoring framework that is expected to be developed by the Authority over the next 12 to 18 months.

Our submission is structured as follows:

(a) First, we identify a number of contextual issues that we think are important for the Authority's cost of capital methodology review.
(b) Second, we briefly outline our expectations for this review and its outcomes.
(c) Third, we address a number of concerns we have about the way in which the Authority is undertaking its review, including proposing a possible framework for the review to provide greater certainty for regulated entities as to the review's scope.
(d) Finally, we have engaged SFG Consulting (SFG) and Synergies Economic Consulting to provide their expert views on the two QCA discussion papers released so far on: Risk and the Form of Regulation and; The Risk-free Rate and the Market Risk Premium. However, we reserve our position on specific matters raised in the two papers until we better understand the scope and end-point of the Authority's review.

Context for this cost of capital review

We support the Authority undertaking a comprehensive review of its cost of capital methodology at this time.

The last comparable review undertaken by the Authority was in 2003-04. Moreover, the global financial crisis (GFC) and subsequent uncertain and volatile financial market conditions have had a significant impact on the outcomes of regulatory cost of capital methodologies applied across Australia, including those of the Authority.

In our view, the impact of the GFC appears to have been the primary driver of a number of current and completed reviews of existing cost of capital methodologies by Australian regulators.
This includes major changes to the cost of capital rules recently implemented by the Australian Energy Market Commission (AEMC) in December 2012 under the national energy framework.[1]

[1] The changes have been reflected in both the National Electricity Rules and National Gas Rules with the intention of creating a consistent framework for the setting of the rate of return across the electricity and gas network sectors and between distribution and transmission service providers within these sectors.

The Australian Energy Regulator (AER) has subsequently commenced a process to develop the prescribed rate of return guidelines. As part of this process, the AER is holding a series of forums and working groups for all stakeholders to discuss issues and identify common views. Similarly, the AEMC adopted an extensive consultative process as part of its consideration of the original rule change requests that culminated in the December 2012 network rules changes. We are attracted to this process and support the Authority undertaking a similar approach.

The Independent Pricing and Regulatory Tribunal (IPART) is also currently reviewing certain aspects of its methodology for estimating the costs of debt and equity for the entities that it regulates. The Economic Regulation Authority of WA (ERA) has also recently commenced reviews of its cost of capital methodologies as they relate to the gas and rail entities that it regulates.

We would expect the important issues raised during these reviews to be thoroughly considered during the Authority's comprehensive review including:

- the need for regulators to take into account a broader range of methods, models and evidence, as well as taking into account the overriding reasonableness of outcomes, when setting the regulated cost of capital;
- the strong likelihood that a 'one size fits all' or mechanistic approach to estimating the cost of debt in the post-GFC environment will be inappropriate for a diverse range of network businesses with likely very different funding arrangements;
- the possibility for a wider range of approaches to be considered in estimating the cost of equity than has occurred in the past;
- how current, historical and forward-looking market data is incorporated into the respective cost of debt and equity estimates, including the internal consistency of these estimates and consistency of the cost of debt and equity estimates more broadly; and
- the rejection of different WACCs for government-owned and private network service providers.

Unitywater's and QUU's expectations for this review

The DRs are currently subject to price monitoring arrangements administered by the Authority under direction from the Queensland Government. Consequently, the significance of the regulatory WACC is its use as a benchmark against which actual returns are assessed to determine whether monopoly returns are being earned.
The price monitoring arrangements have so far have been applied on a rolling basis. The Authority has estimated a WACC benchmark of 6.57% in post-tax nominal ('vanilla') terms for the two-year price monitoring period from 1 July 2013 to 30 June 2015.[2] However, the DRs retain control over their actual WACC assumptions and prices during the monitoring period.

[2] The QCA estimates a nominal post-tax WACC using the Officer (1994) WACC3 model. This approach defines cash flows in nominal, post-tax terms and modifies the cash flows, as opposed to the discount rate, for the debt interest shield and tax, where the latter reflects the effects of dividend imputation.

It is intended that a permanent price monitoring framework be established by the Authority for the period after 30 June 2015. The DRs consider that this cost of capital methodology review should provide clear guidance as to how the WACC benchmark will be set under the permanent framework.

Uncertainty created under existing price monitoring framework

For the DRs, the challenges posed by the impact of more uncertain financial market conditions on regulatory cost of capital methodologies since the GFC have not been reflected in the WACC benchmarks set by the Authority.

For example, the 2012-13 'vanilla' WACC benchmark for SEQ DRs of 9.35% includes a cost of equity estimate (8.85%) that is lower than the cost of debt estimate (9.69%). This appears to contradict the well accepted finance concept of risk and return, such that equity holders bear more risk than debt holders and should be compensated accordingly. We do not accept that this anomaly is explained by the possible difference between the promised and expected return on debt, as previously suggested by the Authority.[3]

Moreover, we do not consider that the allowed cost of debt is a maximum return whereas the cost of equity is an expected return such that the respective returns are not directly comparable. In our view, the expected return on debt is only likely to be lower than the allowed return if there is a material chance of default (i.e. financial distress of the regulated entity). We assume that the Authority is not setting its WACC benchmark based on this assumption.

In addition, the recently announced 'vanilla' WACC benchmark for 2013-15 of 6.57% has almost equivalent costs of equity (6.69%) and debt (6.49%). Moreover, this represents around a 30% fall from the previous WACC benchmark. As discussed in the SFG response to the Authority's Risk-free Rate and Market Risk Premium discussion paper, this reduction is occurring in circumstances where dividend growth models currently indicate that required returns on equity are above their long-run average.[4]

Moreover, this outcome is consistent with observed debt risk premiums, which are undoubtedly at elevated levels. In SFG's view, it is illogical to expect that investors would require risk premiums several times higher when buying debt securities, but then require lower risk premiums when buying equity securities.

In our view, these cost of capital outcomes raise legitimate questions about the robustness of the QCA's existing cost of capital methodology, which need to be considered as part of any comprehensive review.

3 Queensland Competition Authority (2011). Final Report: SEQ Interim Price Monitoring for 2010/11, Part B Detailed Assessment.

4 Debt risk premiums are effectively observable whereas equity risk premiums are compiled from assumptions and estimates of economic models, such as the dividend growth model.

More broadly, changes of this magnitude in cost of capital outcomes significantly undermine the integrity of the WACC benchmark as a basis for determining whether excess returns are being earned. This is because the WACC value directly affects a DR's maximum allowable revenues (MAR) under the Authority's price monitoring arrangements, so a DR's prices could become linked to movements up and down in the WACC as financial market conditions change to ensure actual revenues do not exceed the MAR.

We consider large implied MAR reductions reflecting short term financial market conditions and which are likely to subsequently reverse, to be unhelpful in managing our businesses and customers' price expectations. Moreover, the potential price volatility is inconsistent with the stability one would expect to accompany the use of long life assets financed by long term capital.

In this regard, Unitywater has engaged Education and Management Consulting Services (EMCS) to assist it identify potential solutions in the context of setting the benchmark WACC for the permanent price monitoring framework to be developed by the Authority and applied to the SEQ DRs. Recognising the importance of the issue, EMCS identify a number of alternative ways in which the current inconsistency in the timing of estimated inputs to the Authority's WACC methodology could be addressed.

In our view, what is needed is for the Authority to develop a benchmark WACC range for price monitoring purposes based on paragraph 168A(a) of the QCA Act.[5] This provision is quite explicit in stating that the regulated entity is entitled to a return that *at least* compensates it for its 'commercial and regulatory risks'. That is, the Authority should set the allowed return in line with returns that are actually required in the market.

In our view, the actual required returns are much more stable over time than the outcomes currently being generated by the Authority's mechanistic approach.

It is only from a longer term perspective that sound judgement can be exercised about excess returns being earned by a DR. Moreover, all DRs would benefit from the certainty of knowing what the Authority considers to be an acceptable range of returns from a medium to long term perspective.
We consider that the Authority's cost of capital methodology review is the best vehicle for establishing a WACC value range for DRs under the permanent price monitoring framework to apply beyond June 2015.

Key aspects of future cost of capital methodology

Further to our view that the Authority should develop a stable benchmark WACC range for price monitoring purposes, we see a number of desirable features of the cost of capital methodology as it will be applied to DRs.

[5] The s168A pricing principles in the QCA Act are taken from section 2.4 of the Competition and Infrastructure Reform Agreement (CIRA) signed by the Council of Australian Governments (COAG) on 10 February 2006. These principles formed part of the primary intent of CIRA to achieve a simpler and consistent national approach to the economic regulation of significant infrastructure.

Cost of debt

We consider that the Authority's methodology must recognise that both a trailing average approach (as proposed by Queensland Treasury Corporation (QTC)) and 'on the day' approach (as currently used by the Authority) to estimate the cost of debt can be consistent with efficient financing practices. This will depend on a regulated entity's circumstances, including size, ownership structure, and financing task. Consequently, the Authority's task should be to develop efficient benchmarks for both these approaches, not to choose one or the other as part of its cost of capital methodology.

Moreover, a DR should be able to choose the approach it assesses to be efficient for it, which would then be assessed against the benchmark. Adoption of this approach would be consistent with the recently amended National Electricity Rules, which provides for the return on debt to be estimated based on either of these two approaches.[6] In this regard, QTC has made strong arguments in support of the trailing average approach as an efficient financing practice in the context of the national energy network regulatory framework. In our view, the Authority needs to give consideration to how a trailing average approach could be operationalised as an efficient benchmark.

We would envisage operational detail on the trailing average approach being included in the Authority's cost of capital methodology. We note that under the QTC approach, the regulated entity cannot simply choose the approach that delivers the highest value at the time of each determination.

Cost of equity

As noted above, we consider there to be a significant flaw in the way in which the Authority is currently estimating the cost of equity, which has resulted in historically low regulatory cost of equity estimates.

In our view, the main issue that needs to be addressed is the problem that is created when combining a spot estimate of the risk-free rate with a long-term average market risk premium in volatile market conditions.

In this regard, we do not consider that the Authority's existing approach to estimating the market risk premium is forward-looking.

The SFG response to the Risk-free Rate and Market Risk Premium paper discusses this issue in more detail and shows that the Authority's current approach (including the rounding adjustment to the nearest full per cent) means that there is unlikely to ever be an estimate other than 6%, as reflected in the Authority's estimate of 6% in every decision it has made so far.

6 National Electricity Rules, Chapter 6, paragraph 6.5.2(i).

Possible solutions to this problem of mixing spot and historical average rates is to estimate either a spot market return and deduct a current risk free rate to obtain an estimate of the expected market risk premium or to estimate an expected market risk premium directly. Another solution could be to adjust the long run average market risk premium for changes in the risk free rate relative to the average. Or alternatively one could use historical averages for all variables.

Each of these alternatives has its advantages and disadvantages and the DRs consider that they need to be given consideration by the Authority as part of this comprehensive methodology review.

Other economic regulators have either used or are considering using the various alternatives.

The consistency or not of terms in the cost of equity calculation and the consequences thereof is discussed in more detail in SFG's response to the Authority's Risk-free Rate and Market Risk Premium paper. Dr Stephen Bishop and Professor Bob Officer have also published papers on the issue of estimating the market risk premium in an environment where there has been greater market variability and economic uncertainty than has typically been experienced over at least the past 50 years.[7]

Bishop and Officer consider that because of large increases in debt premiums following the global financial crisis, there is a substantive disconnect between the risk spread on debt and equity when the historical average market risk premium is used to estimate the cost of equity. In their view, and consistent with the findings of SFG's paper, this process substantially under-estimates the required return on equity.

Questions for consideration

In light of our expectations regarding this cost of capital review, there are a number of questions that immediately arise from the Authority's two discussion papers that we would appreciate the Authority commenting upon in responding to stakeholders:

- Does the Authority consider that the pricing principles in section 168 of the QCA Act apply to all entities regulated under the Act and, in particular, does the Authority consider that the requirements of paragraph 168A(a) regarding the setting of regulated rates of return that at least compensate an entity for its 'commercial and regulatory risks'are relevant to this comprehensive review of its cost of capital methodology?[8]

- Does the Authority consider that it should seek to set the allowed return on equity and debt to be consistent with the efficient cost of equity and debt of an efficient benchmark firm at the time of each determination? And if so, on what basis will

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7 Examples include: Bishop S. & Officer B (2009), Market Risk Premium Estimate for January 2010 – June 2014 Prepared for WestNet Energy (December); Bishop S. & Officer B (2009), Market Risk Premium, Further Comments, Prepared for Energy Networks Association, Australian Pipeline Industry Association and Grid Australia (January).

8 The s168A pricing principles in the QCA Act are taken from section 2.4 of the Competition and Infrastructure Reform Agreement (CIRA) signed by the Council of Australian Governments (COAG) on 10 February 2006. These principles formed part of the primary intent of CIRA to achieve a simpler and consistent national approach to the economic regulation of significant infrastructure.

that benchmark efficient firm be defined in relation to the diverse entities regulated by the Authority?

- The Authority's current cost of equity methodology implies that, in the period since the onset of the GFC, equity capital has been cheaper than at any time on record. Can the Authority reconcile this position with the weight of market evidence to the contrary?

- Has the Authority fully considered the investment incentive, market value and equity investor implications of the split cost of capital concept it has raised as part of its risk and form of regulation discussion? And how does the Authority reconcile the material regulatory risks inherent in the concept with its view that economic regulation as applied in Australia is 'relatively low risk'[9]?

The Authority's cost of capital review framework

The QCA has indicated that it is undertaking a comprehensive review of its cost of capital methodology and that it will be preparing discussion papers on various topics relevant to determining the cost of capital. These papers, in conjunction with stakeholders' submissions, will inform the Authority's position on a particular topic.
The Authority will then prepare position papers on the key parameters for its cost of capital methodology.

However, there are no further details on how the Authority will undertake its review, including scope, objectives and time frames. In our view, there is a need for an overarching framework to guide the Authority's analysis and decision-making.
Moreover, elements of the two discussion papers released so far read more like position or decision papers with the Authority appearing to have settled on its preferred approach. We do not consider this to be appropriate in the context of a comprehensive review of its cost of capital methodology.

In addition, the DRs do not believe that undertaking this review using a piecemeal approach, in isolation of discussions on other WACC parameters and the financial and economic issues that drive these parameters to be a prudent approach. Consequently, as a starting point, we consider it imperative that the Authority's review has regard to the requirements of 168A(a) of the QCA Act. This provision is quite explicit in stating that a regulated entity is entitled to a return that at least compensates it for its 'commercial and regulatory risks'.

Within the context of this requirement, the scope of the regulated cost of capital is narrower (than 'commercial and regulatory risks'), and is simply to provide a return on equity that is commensurate with the relevant systematic (or non-diversifiable) risks, and a return on debt that reflects the prevailing cost of funds based on the assumed notional credit rating.

9 Queensland Competition Authority (2012), Risk and the Form of Regulation, Discussion Paper, p vii.

However, the regulated cost of capital does not address diversifiable risks (which may or may not be otherwise compensated in the cash flows), nor does it address asymmetric risks, such as asset stranding. It also does not address regulatory risk. In our view, these issues should be acknowledged and addressed as part of the Authority's review.

We also see merit in the Authority developing guiding principles/objectives to guide how it will assess and approve regulated entity's rate of return proposals. The Authority has significant discretion under the QCA Act in assessing rate of return proposals and a small number of guiding principles would provide greater predictability to regulated entities regarding its approach. As previously noted, the AER must develop such guidelines under the national energy regulatory framework and has arranged stakeholder forums to enable broad ranging input into their development.

In particular, a principle to identify and explain clearly where and when the Authority has made the necessary trade-offs between precision in its estimates of parameter values and the overall reasonableness of its cost of capital estimates would directly address the issue of the exercise of regulatory discretion.

Given the discretion the Authority has under the QCA Act, there appear good grounds for going one step further and the Authority developing guidelines to set out its approach to setting the cost of capital for the diverse range of entities it regulates. This approach is adopted under the national energy framework, which also provides for overarching rules to guide the regulator's cost of capital determinations and mandatory three yearly reviews of the guidelines. In prescribing this three year timeframe, the AEMC noted that it would allow stakeholders to consider new evidence or analytical techniques that may allow better estimates of the rate of return to be made.[10]

In conclusion, we consider there is a need for a framework for the current cost of capital review that should, at a minimum, address the following matters including:

- the objectives of the review;
- the exact scope of issues that the review will address, as well as how the outcomes of the review will impact on the different entities regulated by the Authority;
- the merits of developing guiding principles and/or guidelines to indicate how the Authority will apply its cost of capital methodology in the future;
- evaluation criteria regarding how feasible cost of equity and cost of debt options will be evaluated during the review and reflected in the final methodology; and
- structured consultation and publication time frames, including workshops with the entities it regulates.

[10] Australian Energy Market Commission (2012), Draft National Electricity Amendment (Economic Regulation of Network Service Providers) Rule 2012 Draft National Gas Amendment (Price and Revenue Regulation of Gas Services) Rule 2012, Draft Determinations, p 21.