

Our ref: A2243636

Dr Malcolm Roberts
Chairman
Queensland Competition Authority
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Brisbane QLD 4001

24 April 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 Issues Paper released by the Queensland Competition Authority (QCA) on 20 March 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) and that the WACC calculated delivers sufficient returns to support prudent and efficient investment in water and sewerage infrastructure.

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 to avoid customer price shocks as well as guiding participant's expectations. Since 2010 when the SEQ Water distributor-retailers became subject to economic regulation, the allowed rate of return has varied significantly:

	2010-11 to 2012-13	2013-14 to 2014-15	Movement
Cost of Debt	9.69%	6.49%	3.20%
Cost of Equity	8.85%	6.70%	2.15%
Nominal Post Tax	9.35%	6.57%	2.78%

For every \$100 received from a customer around \$15 now goes towards the cost of debt compared to \$18, therefore there is a high incentive to manage this cost and it's variability.

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.

During 2012-13 Unitywater entered into new funding arrangements. In the absence of clarity over the future form of regulation for SEQ water distributor-retailers, Unitywater sought 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. This has been achieved through a portfolio of fixed rate debt with staggered maturities out to approximately ten-years. The portfolio cost of debt is updated each year to reflect the interest rates on refinancing and new borrowing transactions performed during the year.

Unitywater therefore supports the use of a trailing average approach (which applies to the total cost of debt) to calculate the regulated cost of debt and the comments submitted by the Queensland Treasury Corporation (QTC) with respect to this matter. 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 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
- 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