

Brisbane City Council's Comments on the Draft Report for 2010/11 Interim Price Monitoring of SEQ Water and Wastewater Distribution and Retail Activities

Comment on Proposed WACC

General Approach

The Queensland Competition Authority (QCA) is proposing to use a WACC of 9.35% for each year of the interim price monitoring period. For this review the QCA has adopted its standard approach to estimating the WACC. The QCA's approach is to estimate a nominal post tax WACC using the 1994 WACC3 model.

The cost of equity is estimated using the Officer (1994) version of the Capital Asset Pricing Model (CAPM) where returns are defined to include dividend imputation credits to the extent that they are usable.

BCC has no issue with the WACC approach adopted by the QCA.

The main difference in QUU's (and the other water and wastewater entities') WACC parameters is in the term of the risk free rate and debt margin. The QCA seeks to match these to the term of the regulatory period whereas the water entities align these rates to a longer term, QUU to the 10 year Commonwealth bond rate.

Risk-free Rate

BCC agrees that if the interim price monitoring is for a three year period from 1 July 2010 to 30 June 2013, and the risk-free rate is set at the three-year Commonwealth bond rate, that the risk-free rate should be based on a 20 day averaging period.

Assets are normally built to produce a targeted return on investment over their economic life, not necessarily over a short-term regulatory period. When BCC performs such calculations it uses a 10 year Commonwealth Bond rate as the risk free rate. It could be argued that if the approach is to use a three year Commonwealth bond rate as the risk-free rate then the debt / equity mix should be adjusted accordingly. For example on new projects the leverage is typically higher for longer term investments as compared to shorter term investments. Shorter term investments possess significantly higher risks (due to refinancing / reinvestment risk as well as start-up risk) and thus usually require a higher percentage of equity.

The QCA approach derives the debt / equity mix from gearing ratios of comparable listed companies. These gearing ratios are not based on three year investment cycles but rather whole of life outcomes. Hence, the industry standard has been to base the risk free rate on the ten year Commonwealth bond rate.

This argument brings into question another proposed WACC input, the capital structure, that being a 60% debt gearing position. Using the averaged leverage

numbers from the Australian gas and electricity networks may not be optimal given this 3 year regulatory period and pricing structure.

BCC offers this comment for consideration.

Market Risk Premium (MRP)

BCC has no issue with the adopted 6% MRP but has observed elsewhere the use of a 7% MRP in the calculation of the Cost of Equity.

Capital Structure and Credit Rating

In addition to the above comments regarding capital structure BCC has no issue with the adopted benchmark of 60% debt and 40% equity and the associated BBB+ credit rating assigned to the entities. This capital structure is seen to be efficient and given that the actual capital structures of each entity can be varied to gain advantage BCC has no issue with this WACC input.

Asset and Equity Betas

BCC acknowledges that QUU has proposed an asset beta of 0.43, providing an equity beta of 0.84. QUU believed that an asset beta was appropriate given that recent QR decisions applied an asset beta of 0.45 and AER's energy equity beta of 0.8.

The QCA has used an asset beta of 0.35 and an equity beta of 0.66. The QCA's decisions have been drawn from Dr Lally's analysis of comparable water and utility companies in Australia and in the US and UK. The QCA has used the Conine beta levering formula.

BCC has no firm view on these Beta values but acknowledges the approach taken by both parties.

Debt Beta

BCC has no issue with the proposed Debt Beta.

Cost of debt

BCC has considered QUU's proposed cost of debt. This value of 10.11% includes a debt margin of 4.68%. The QCA proposes a cost of debt of 9.69% with a debt margin of 4.78%.

We believe that the approaches taken by QUU and the QCA in determining this cost are reasonable, and therefore fall within a reasonable range for the cost of debt.

Gamma

BCC has no issue with gamma value of 0.50.

Conclusion

All parties have presented rationales on the WACC methodology supported by external experts. BCC does not seek to rank the methodologies yet acknowledges that the overall WACC rates are within a reasonable range and consistent with our WACC expectations.

Other Comments

Tax

The treatment of capital contributions has an effect on the tax calculation and the MAR value under the proposed model.

QUU comes within the State's Tax Equivalents Regime as set out in the Local Government TER Manual. Under the ruling on contributed assets (capital contributions) (LITER 98/20), the basic position is that specific contributions towards identified assets are not assessable income and depreciation cannot be claimed. Where cash is received and is not specifically related to an asset then the cash is assessable income.

The TER manual was written in 1998 in response to National Competition Policy legislation. The manual was not designed for complex restructures such as what has occurred in the water industry. As LITER 98/20 notes "The proper tax treatment of non-refundable assets acquired free of charge or of non-refundable contributions towards the costs of assets is not entirely clear". It may be worthwhile for the water entities and the QCA to seek a joint ruling on this matter from the TER Tax Assessor.

It could be argued that contributed assets are a form of equity. Their identification as equity would allow a similar treatment of both physical and cash assets and then allow these values to be incorporated into pricing considerations through return on equity calculations.

Impact of Floods

The QCA has noted that the impact of the floods has not been taken into account in this report. For example, the capital expenditure required to repair damage to water infrastructure, wastewater treatment plants and related pump station issues (in QUU's area) needs to be considered for its future impacts. There are also associated operational costs from the floods.

Future capital expenditure assigned in the forward estimate costing for flood damaged assets may need to be brought forward to cover repair costs or replace flood damaged assets. This could impact on the proposed MAR estimates. It does however highlight the issues that arise when operations are not running as "Business as Usual". Exceptional circumstances (i.e. acts of nature, severe destruction or unseasonal weather conditions) need to be considered and a proposed pricing structure and price smoothing process prepared in advance to avoid large variances in prices as a result of exceptional circumstances.

Price Setting for Large Infrastructure Costs into the Future

Large future costs whether they are planned or unplanned need to be accounted for in some way to avoid future price shocks for consumers. Ideally prices need to be set and smoothed over a longer period than this current three year process to avoid large variations in price.

Recoveries on infrastructure are contained within the MAR calculation. Infrastructure charges under the infrastructure charging regimes also assist with cost recovery. These two charging mechanisms should be considered together.

BCC is cognisant of the need for the water entities to operate efficiently and to be fully funded so that the community does not have to pay excessive water prices. Our view is the same for all utilities.