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Charles Millstead  
Chief Executive Officer  
Queensland Competition Authority  
GPO Box 2257  
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Dear Mr Millstead

Thank you for an opportunity to comment on, and contribute to, the Queensland Competition Authority's (QCA's) inflation forecasting review.

For Sunwater, inflation is currently applied in modelling to index the annuity revenue allowances, calculate the real weighted average cost of capital (WACC), escalate certain cost categories like materials and insurance, roll-forward the allowed capital expenditure for the Dam Improvement Program in the Regulatory Asset Base (RAB), etc. It is also used to establish recommended prices. Specifically, the QCA first derives cost-reflective prices and, for tariff groups with below lower bound prices, applies a measure of inflation to transition prices to the lower bound cost target.

Sunwater notes that while the current period of low inflation has been exacerbated by the COVID-19 pandemic, the market's recent inflationary expectations are increasing in response to unprecedented global stimulus measures. We therefore caution against adopting methods that are specifically designed to address this extraordinary period, as such methods may not be fit-for-purpose once there is an uplift in inflation. Sunwater is particularly concerned about volatility between regulatory periods when moving from a low inflation period to a higher inflation period, and the impact on irrigation prices.

In addition to the above recommendation, Sunwater has the following comments in response to the QCA's questions.

#### *Term for forecasting inflation*

Sunwater is receptive to the term of the expected rate of inflation being aligned with the length of the regulatory period. This will remove the current mismatch between the term of expected inflation used in the

WACC and the RAB roll-forward. It will also reduce uncertainty about the estimated inflation and assign greater weight to the conditions of the regulatory period.

#### *Other uses of inflation*

Sunwater supports a framework that will continue to allow different escalation factors to be applied to different cost categories, as appropriate. For example, labour costs could be escalated by the rate/s included in an Enterprise Agreement and/or the average wage price index for all sectors in Queensland, while materials could be escalated in line with the consumer price index.

#### *Methods for estimating expected inflation*

Currently applied methods were designed with an aim of longer-term forecasts. Provided transparency is maintained, Sunwater is open to the adoption of other methods, such as the linear glide path approach explored in the QCA's issues paper, to estimate expected inflation. Such methods may result in a gradual, less volatile year-on-year change in expected inflation than currently applied methods and potentially reduce the difference between estimates of expected inflation and actual inflation.

However, as highlighted above, we caution against adopting methods specifically designed to address the current low inflation environment, especially given the recent increased inflationary expectations of the market.

If the QCA chooses to amend its current methods, Sunwater suggests that the inputs should be publicly available, so that stakeholders, including customers, can assess how the inflation forecasts have been derived.

#### *National or state capital inflation*

To reflect the local nature of the business, Sunwater considers that the QCA should apply Brisbane and/or Queensland-based measures, including for particular cost escalation factors such as the wage price index.

Thank you once again for the opportunity to contribute to this process. If you would like to discuss any element of this submission, please contact Rachel Collins, A/Regulatory and Pricing Lead.

Yours sincerely



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