EVANS & PECK

Queensland Competition Authority

SEQ Retail Water Price Review

4 February 2013

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1   PROJECT BACKGROUND

The Premier and the Treasurer have referred the monopoly distribution, retail and wastewater activities of five water utilities in South East Queensland to the Queensland Competition Authority (QCA) for a price review covering a monitoring period of 1 July 2013 to 30 June 2015.

Evans & Peck have been appointed to provide input to work being undertaken to assist on deriving the Weighted Average Cost of Capital (WACC) for these regulated water utilities; namely Redlands, Logan, Queensland Urban Utilities, Gold Coast and Unitywater (the 'Entities').

Specifically Evans & Peck has been asked by QCA to assist with providing pricing for interest rate swaps (IRS) to determine the efficient benchmark cost of debt for these Entities based on their probable commercial debt funding behaviour in the market.

2   METHODOLOGY AND SUMMARY OF INPUTS

QCA have determined that typically these Entities fund themselves on the debt side with an average of 10 year fixed rate bonds. However the regulatory periods for resetting pricing will be 2 years. QCA have to adjust the two components of any cost of debt, the risk free rate and the debt premium, to the shorter periods for the purposes of WACC modelling. The risk free rate can be adjusted on the basis of interest rate swap pricing.

A. Basic information:

1. Enterprise Value: The Entities' regulatory asset bases (RAB's)

RAB	2013	2014	2015
	1-Jul-13	1-Jul-14	1-Jul-15
	$'000	$'000	$'000
QUU	4,790,000	5,234,000	5,605,000
Unitywater	3,015,000	3,222,000	3,297,000
Redlands	490,000	528,000	522,000
Logan	1,290,000	1,408,000	1,396,000
Gold Coast	2,697,000	2,883,000	2,859,000

These RAB's are based on the Entities' submissions and have been assumed to escalate at 2.5% pa into the future after 2015 to represent inflation, as requested by QCA. Importantly, the enterprise value used is equated to the RAB as per QCA's request. The gearing used is 60%. That allows the underlying amount of the debt of each entity, both now and into the future, to be derived. This will in turn give the underlying nominal principal amount of the debt for swap pricing. Other assumptions are:

2. The credit rating is assumed to be BBB, and then BBB+ is provided as a sensitivity.

3. As explained below, the IRS are hypothetically transacted on 10 and 2 year tenors.

4. The swaps were priced as if transacted at 10.00am on 22 January 2013.

B. Mechanism:

Dealing with the interest rate swaps:

1. For each hypothetical swap, the execution and risk spreads can be derived. The swap is assumed to be to BBSW (mid-market swap rate). The swap spreads are not further adjusted for the timing of any difference payments (calendar quarters, monthly etc. rather than quarterly as quoted).

2. For the principal profile defined above, the swap from 10 year fixed to 10 year floating can be derived –as well as the spread breakdown for each Entity; then the spread from floating to 2 year fixed can be derived – and the spread breakdown.

3. The execution spread is an estimate of the buffer that a bank levies for fluctuations in the market while the back-to-back transactions are placed. The risk spread is an estimate of the charge that a bank makes for the risk of the counterparties (the Entities we are dealing with) defaulting – most likely for non-payment.

C. Basis for swap rate derivation and spreads:

The fixed rates in the table below are based on the prevailing mid inter-bank market Australian dollar swap rates as published in ICAP (an inter-bank broker) on Reuters page ICAPAUSWAPS01 and relevant basis swap markets as published on Reuters page ICAPAUBASIS (same publisher) as at 10.00am Australian Eastern Daylight Savings Time on the date requested (22 January 2013).

The rates are mid-market (BBSW). An increase of 5bps will need to be applied to convert to the bid rate (BBSY bid). This adjustment is needed if the margins quoted on the debt are margins to BBSY bid, which is common, but not needed if the margins are to BBSW.

The credit spreads are based upon the requested rating (BBB) and BBB+, specified tenors (2 and 10 years) and an internal bank process which is representative of the market. Execution spreads are based on current market pricing and a bank's internal pricing model.

3 SUMMARY OF RESULTS

The table below gives a summary of results. Points to note are:

i) The pricing has been carried out for both BBB and BBB+;

ii) The pricing of a swap from fixed to floating is virtually (but not exactly) the same as for the reverse swap – but within the limits of this exercise the difference is not material. Thus only one set of pricing has been given for any swap, be that fixed to floating or floating to fixed;

iii) The pricing for the two stage swaps can be derived by adding the spreads for the first swap to those of the second. For example, the cost of swapping the 10 year fixed, BBB rated debt to 2 year fixed, BBB rated debt = (0.055 + 0.040) + (0.020 + 0.020) = 0.135

22 Jan 2013	2 Year		3 Year		5 Year		10 Year	
	BBB	**BBB+**	**BBB**	**BBB+**	**BBB**	**BBB+**	**BBB**	**BBB+**
Execution Spread (%)	0.020	0.020	0.025	0.025	0.030	0.030	0.040	0.040
Risk Spread (%)	0.020	0.018	0.025	0.020	0.035	0.030	0.055	0.045

iv)   For completeness, the mid-market swap rates (basis adjusted) for 10.00am on 22 January 2013 on a quarterly basis were:

Swap Tenor	2 years	10 years
Rate vs BBSW	2.915%	3.862%

To give high level market context, since March 2012, debt pricing has generally decreased – and as at January 2013, there has been some further recent pricing relief due to the advances in debt management in the Eurozone, including the ECB provided liquidity and "positive-sounding" policy decisions. In addition, sentiment has changed about yield and the Eurozone, and as a result there has been an exit from sovereign low yield exposure into higher yield and Eurozone currencies and credits. This reweighting (especially into higher yield credits) has resulted in margin compression in the Australian market. In addition, the cost of funds for Australian banks has started to fall, and due to the above effects and an oversupply of money in Australia, debt pricing as indicated has fallen. Swap credit margins have followed suit and have contracted in domestic markets (reflecting credit spread movements in the Eurozone). Liquidity and competition in the swap market remain high and strong. Many Eurozone names are exiting the market but are being replaced by Canadian and Japanese investors; and the market has taken into account a pending increase in Chinese presence in the Australian market.