

FACT SHEET – WACC UPDATE

February 2014

Introduction

As part of our 2013 review of our WACC methodology, we decided to release a bi-annual financial market update. This is the first of our bi-annual financial market updates. The purpose of this update is to allow our stakeholders to better replicate and predict our WACC decisions. In conjunction with the update, we are also releasing a WACC spreadsheet which includes a working copy of our full WACC model. This model will be updated to reflect the data inherent in the periodic releases of financial market updates. Future financial market updates will be released bi-annually in February and August.

Outlook

Summary

- ▼ Since mid-2013, midpoint WACC estimates have increased marginally and WACC ranges have narrowed.
- ▼ The uncertainty index is currently close to its long term average value of 0. This supports continuing to use the midpoint WACC.
- ▼ The accompanying spreadsheet contains the full calculation of our WACC.¹

Estimated WACC parameters and range based on an equity beta of 1 and a gearing ratio of 60%²

Table 1 Market-based parameters as of 31 January 2014

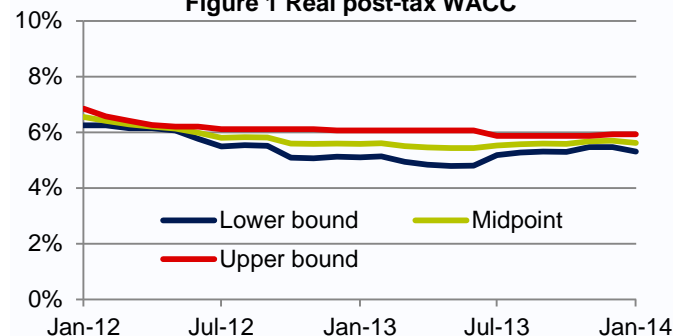
	RFR	DRP	MRP	Inflation
40 days	4.2%	1.5% ^a	7.9% ^a	2.8%
10 years	5.1%	2.5%	6.0% ^a	2.9%
Midpoint	4.7%	2.0%	7.0%	2.9%

^a Midpoint estimate.

Table 2 IPART's final WACC range as of 31 January 2014

	Lower	Midpoint	Upper
Nominal Vanilla WACC	8.3%	8.6%	9.0%
Real post-tax WACC	5.3%	5.6%	5.9%

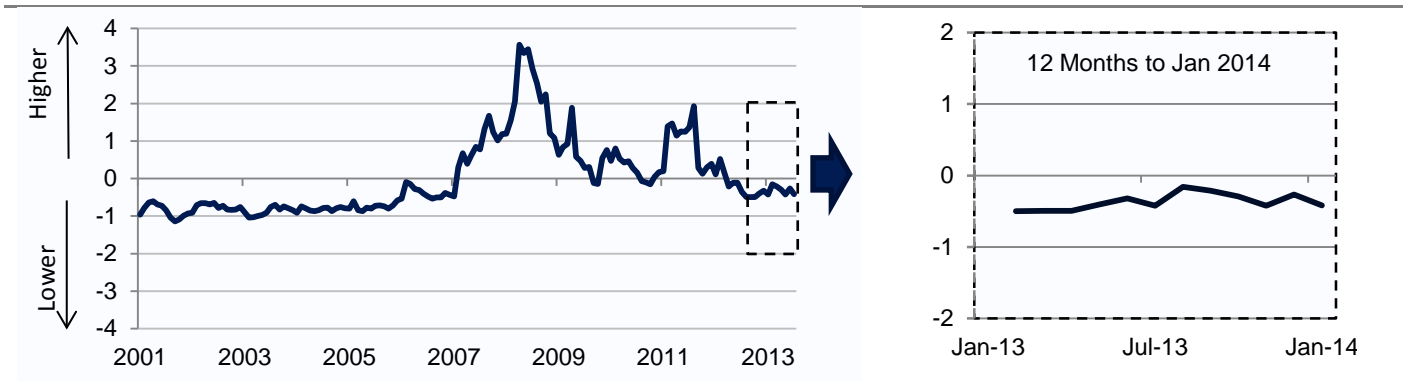
Figure 1 Real post-tax WACC



¹ For industry-specific WACC estimates, select industry from the drop-down menu in the accompanying spreadsheet.

² RFR, DRP and MRP in Table 1 refer to risk-free rate, debt risk premium, and market risk premium. RFR, DRP, MRP and inflation are midpoint values and expressed in nominal terms. The WACC estimates in Table 2 are post-tax WACCs and based on an equity beta of 1, 10-year target term-to-maturity and a gearing ratio of 60%.

Figure 2 Economic uncertainty



- ▼ The index shows that economic uncertainty has trended down following positive spikes in 2008, 2009 and 2011.
- ▼ The uncertainty index is close to 0, suggesting uncertainty is currently in line with, or slightly below, the long term average.
- ▼ The current level of the uncertainty index supports continuing to use the midpoint WACC.

Analysis

Table 3 Industry-specific WACC parameters^a

Sector	Beta			Target term-to-maturity	Gearing ratio
	Low	Mid	High		
Water^b	0.60	0.70	0.80	10 years	60%
Public transport^c	0.80	0.90	1.00	10 years	60%
Electricity generation	0.95	1.05	1.15	10 years	40%
Electricity retail	0.90	1.00	1.10	10 years	20%

^a Note that we review industry equity beta and gearing ratio at each price determination.

^b Applicable to Essential Energy Water, Hunter Water Corporation, Sydney Desalination Plant, Sydney Catchment Authority, Sydney Water Corporation, Gosford City Council and Wyong Shire Council as of 31 January 2014.

^c Applicable to CityRail as of 31 January 2014. Note that we determine separate WACCs for Sydney Ferries and Metropolitan and Outer Metropolitan Buses.

Industry WACC midpoints and ranges based equity beta and gearing ratio in Table 3³

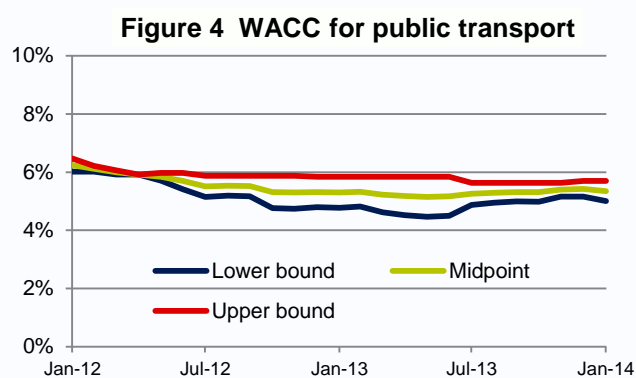
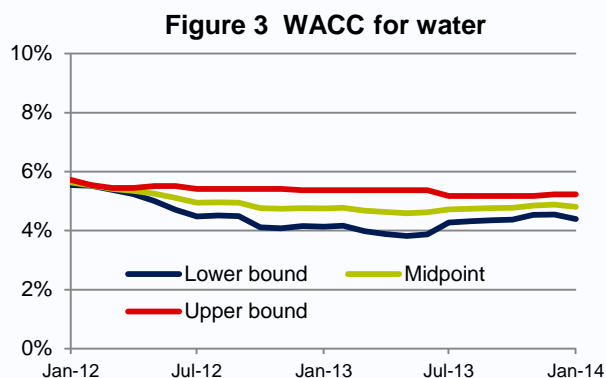


Table 4 Half-yearly WACCs for water

	Jan-12	Jul-12	Jan-13	Jul-13	Jan-14
Upper	5.7%	5.4%	5.4%	5.2%	5.2%
Midpoint	5.6%	4.9%	4.7%	4.7%	4.8%
Lower	5.5%	4.5%	4.1%	4.2%	4.4%

Table 5 Half-yearly WACCs for public transport

	Jan-12	Jul-12	Jan-13	Jul-13	Jan-14
Upper	6.5%	5.9%	5.8%	5.6%	5.7%
Midpoint	6.2%	5.5%	5.3%	5.2%	5.3%
Lower	6.0%	5.2%	4.8%	4.8%	5.0%

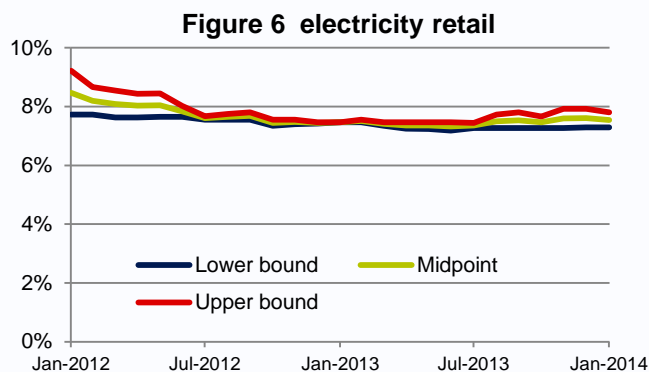
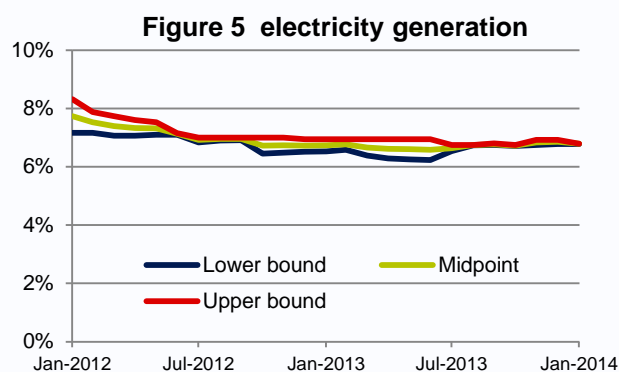


Table 6 Half-yearly WACCs for electricity generation

	Jan-12	Jul-12	Jan-13	Jul-13	Jan-14
Upper	8.3%	7.0%	6.9%	6.7%	6.8%
Midpoint	7.7%	6.9%	6.7%	6.6%	6.8%
Lower	7.2%	6.8%	6.5%	6.5%	6.8%

Table 7 Half-yearly WACCs for electricity retail

	Jan-12	Jul-12	Jan-13	Jul-13	Jan-14
Upper	9.2%	7.7%	7.5%	7.4%	7.8%
Midpoint	8.5%	7.6%	7.5%	7.3%	7.5%
Lower	7.7%	7.5%	7.5%	7.3%	7.3%

Uncertainty index

- ▼ The uncertainty index incorporates 4 key financial market indicators. As of 31 January 2014:
 - Expected equity market volatility is currently **below average**.
 - Dispersion in analysts’ forecasts is currently **slightly below average**.
 - Credit spread is currently **below average**.
 - Bills-OIS spread is currently **below average**.
- ▼ The uncertainty index is currently within 1 standard deviation from the long term average.
- ▼ The methodology for the uncertainty index and our decision rule relating to moving away from the midpoint WACC are provided in the *Review of WACC Methodology - Final Report*.⁴

³ WACC ranges based on IPART’s new WACC methodology.

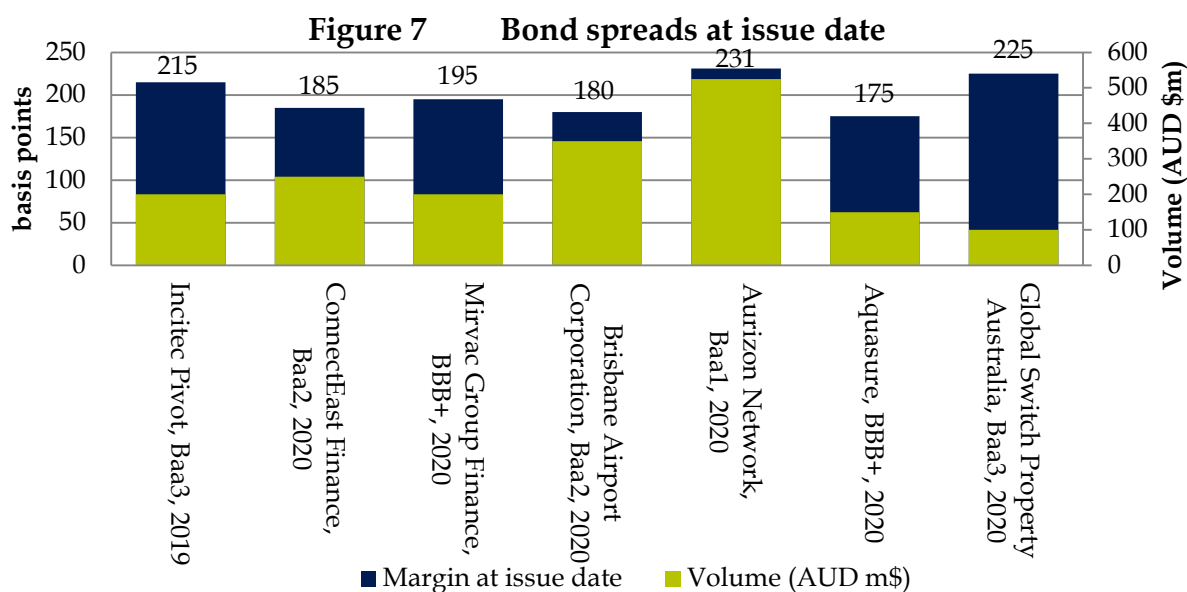
⁴ IPART, *Review of WACC Methodology - Final Report*, December 2013.

Table 8 Additional financial market and economic information

	Cost of Debt	Cost of Equity
1. Market Data	Conditions favourable	Conditions favourable
2. Analyst Reports	Stable	Stable
3. Expert Consultant Reports	Stable	Stable

▼ **Market data:**

- Liquidity in bond markets is improving in the aggregate BBB category. Spreads are around the 200 basis points mark for BBB rated category with terms-to-maturity between 5 and 7 years (Figure 7)⁵.
- The 10-year bank bill swap rate is at 4.48%⁶, 81 basis points up from last year’s low of 3.67% on 7 May 2013.
- Current market sentiment indicates that initial public offering (IPO) activity is likely to return to pre-GFC levels. 2013 ended strongly with companies such as OzForex Group, Veda Group and Steadfast Group rising more than 40% from their offer prices compared with an 11.6% gain in the ASX200.⁷ Australian companies raised around \$6 billion in equity finance in 2013 and this could exceed \$10 billion in 2014.⁸



⁵ Kanganews and Thomson Reuters Eikon. Figure 7 shows the spreads over the swap rate of recent bond issues at the issue date. The Aurizon Network bond is priced over the 7-year Commonwealth Government Security yield. All other bonds price over Bank Bill Swap Rate. X-axis labels show name of issuer, credit rating and year of maturity. Data label inside column shows spread at issue.

⁶ Close on 14 February 2013. Source: AUIRS10Y (10-year Australian Dollar inter-bank swap rate) on Thomson Reuters Eikon.

⁷ Elzio Barreto and Jackie Range, “Australia’s IPO Resurgence to Keep Bankers Busy Next Year”, Thomson Reuters Eikon, 9 December 2013.

⁸ Source: David Gary, head of equity capital markets, JPMorgan. Cited in NewsRoom, “Optimism on Tap as 2014 Float Pipeline Swells to Over \$11bn”. Thomson Reuters, 30 January 2014.

▼ **Analyst reports:**

- We have reviewed recent equity analyst reports on utilities and the utility sector.⁹
- Analysts have not significantly changed their cost of capital assumptions (ie, risk free rate, MRP and debt risk premium) over the last 6 months.
 - For example, Moelis & Company uses a risk free rate of 5.5% and a MRP of 6% in their 28 January 2014 valuation of Aurizon.
 - Deutsche Bank uses a risk free rate of 6.0%, a MRP of 6.5% and a debt risk premium of 1.9% in their valuation of the APA Group in their 17 December 2013 valuation.

▼ **Expert consultant reports:**

- A recent Independent Expert report prepared by Deloitte¹⁰ uses the following WACC parameters in their valuation:
 - a risk free rate: 10-year Commonwealth Government Security yield of 4.3%
 - a 350 basis points debt risk premium over the risk free rate
 - a MRP of 7%.

Upcoming IPART WACC decisions

Table 9 IPART forthcoming WACC decisions to end of June 2014

	Draft decision	Final decisions
Essential Water	March	June
Valuer General	April	May
Rail Access regime	April	June
Gas retail	April	June
Electricity retail	April	June

⁹ Deutsche Bank and Moelis & Company - no other relevant analysts' reports were available on Thomson Reuters Eikon in the 6-months leading to 31 January 2014.

¹⁰ Deloitte, Independent Expert's report prepared for Greencross Limited, 11 December 2013.