

21 October 2011

Mr Jim Cox
Chief Executive Officer
Independent Pricing and Regulatory Tribunal
Level 8, 1 Market Street
Sydney NSW 2000

Dear Mr Cox,

Further to our discussions earlier this week, we have conducted a thorough review of public documentation to further support the cost of equity as submitted in the Sydney Desalination Plant Pty Ltd (SDP) 2012 pricing determination submission. The cost of equity submitted reflected our view of the risk profile of the desalination plant. The review encompassed:

- Comparable regulatory regimes and their regulatory determinations for comparable assets
- Consultants' reports that inform those determinations and associated stakeholder submissions; and
- Relevant market data.

The key findings of this review are detailed in the attached paper, together with the underlying source documentation, and can be summarised as follows:

- Estimating equity beta
 - There are a number of methodologies and parameters which can be varied in determining theoretical estimates of equity beta
 - The various approaches can lead to materially different results when used in the CAPM to estimate the cost of equity
 - It is evident that equity beta estimates used in the CAPM can and do arrive at a cost of equity that is well below the cost of equity required by the market given the risk profile of the asset being funded. This emphasises the importance of sense checking CAPM results against market based estimates of the overall cost of equity
- OFWAT is a relevant regulatory precedent
 - OFWAT's PR09 determination for the period 2010-15 was reviewed, given the comparable asset class, regulatory framework and level of market volatility that prevailed at the time of the determination
 - The determination demonstrated OFWAT's willingness to look through theoretical estimates of equity beta and determine a cost of equity based on the overall cost of equity which would be required to enable efficient companies to maintain access to the capital markets
 - OFWAT used an equity beta of 0.90 in their final determination which was at the top of Europe Economics' (their engaged consultants) 0.48-0.92 view and well above their initially recommended theoretical equity beta of 0.62

- When OFWAT considered beta it concluded theoretical equity betas were very low compared to the market and historic trends and that low equity betas in the water sector may be a statistical product of market volatility
- Furthermore Bristol Water disputed their PR09 determination and were referred to the Competition Commission, which subsequently increased Bristol's equity beta from the 0.90 set by OFWAT to 0.92 based on the argument that OFWAT had not satisfactorily reflected the systematic risks that Bristol Water faced as a small water only company
- UK electricity and gas transmission and distribution networks should also be considered
 - The Competition Commission when dealing with the Bristol Water referral commented that *“Electricity and gas transmission and distribution companies...were often thought to have systematic risk not dissimilar to water companies”*
 - Ofgem is currently considering the 2013 electricity and gas transmission and distribution price control reviews. The Electricity Networks Association has commissioned Oxera to undertake an independent assessment of the initial cost of equity. This report addresses the challenges of applying the CAPM framework in the current market environment and noted that estimates of beta over recent years are lower than longer term estimates, notwithstanding that there is no independent evidence supporting a decrease in the risk profile of these companies. The report also raised the need to cross check the cost of equity derived by the CAPM with the return earned by debt holders and the results of the dividend growth model

All of the above is consistent with the position that the cost of equity applied in determining SDP's prices should be consistent with the actual market cost of equity necessary to attract new investment, and commensurate with the true systematic risk of the desalination plant.

Should you or your staff wish to discuss this further please contact either myself on [REDACTED] or Alan Ramsey on [REDACTED]

Yours sincerely,



Kerry Schott
SDP Project