New approach to forecasting the WACC inflation adjustment

March 2015

We have reviewed our approach to estimating the inflation adjustment for our real post-tax WACC. Our final decision is to use:

- A 10-year geometric average of the one-year RBA inflation forecast and the middle of the RBA’s target band of inflation, ie, 2.5%, for the remaining nine years.

We released a Fact Sheet in December 2014 and received submissions from Sydney Water Corporation and Hunter Water Corporation.

The submissions welcomed our review and acknowledged that our proposed approach delivers significant improvements compared to our previous methodology. They pointed out two possible improvements:

1. **Providing greater consistency between the WACC inflation adjustment and the RAB indexation by using headline rather than underlying inflation.**

   *Our response:* Our view is that this statement is correct and we have concluded that changing from underlying to headline inflation provides consistency between the WACC and the RAB indexation. We will consider any exogenous effects on prices separately. We did this in the past, for example, when we included the effects of the introduction of the carbon tax in the opex rather than in the annual CPI adjustment to prices.

2. **Ensuring a better forecast of actual inflation by using only the first year of the RBA’s forecast of headline inflation and the middle of the RBA’s target band of inflation, ie, 2.5%, for the remaining nine years.**

   *Our response:* The submissions have provided new evidence demonstrating that the one-year RBA forecast outperforms the midpoint of the RBA’s target range of inflation as a predictor of expected inflation, while the second year RBA forecast does not. On balance we have decided to use the first year instead of two years of RBA inflation forecasts. This change in methodology will provide greater certainty to utilities and their shareholders.

---

1 Obtained from RBA statements on monetary policy.