This submission from Sydney Desalination Plant (SDP) is in response to IPART’s further request for stakeholder comments on the proposed changes to the methodology for the calculation of WACC parameters, as set out in the IPART Draft Report dated September 2013 (Draft Report).

SDP notes that following submissions from a number of regulated businesses recommending changes to the proposed methodology, the WACC methodology in the Draft Report for regulated utilities is largely unchanged from the IPART WACC Methodology Interim Report dated 17 June 2013 (Interim Report). As a result, the structure of our submission is focused on improving the consistency of future determinations and managing the changes.

The inconsistent application of term-to-maturity across industries.

As set out in the Draft Report, IPART will “use a 5 year term-to-maturity for all industries except for electricity generation, electricity retail, coal mining and gas businesses” (ECG businesses). For the ECG businesses the term-to-maturity to be used will be 10 years, “reflecting the expected life of the assets and financing practices of competitive businesses with long-lived assets”.

SDP acknowledges the merits of the 10 year term-to-maturity (10 year TOM) for all businesses with long-lived assets. The “other industries”, in particular those that do not receive financing from NSW Treasury operate in the same domestic and international financial markets as the ECG businesses, compete for capital against ECG businesses and have asset lives of similar if not longer than ECG businesses. Consequently, there is no need to distinguish between ECG businesses and those “other businesses” in the application of the 10 year TOM where those businesses have long lived assets and operate in the same financial markets.

Importantly, for privatised utilities such as SDP, the use of the 10 year TOM aligns to the long term nature of the investment sentiment by long term owners such as pension funds with ongoing pension obligations. Its use would also represent efficient and prudent financing practices for the benchmark entity to reduce refinancing risk.

Given these facts, the comment by IPART that 10 year TOM will only apply to businesses that face competition in the supply of their goods or services does not explain the more restrictive treatment by IPART to the other industries. In the Draft Report, IPART provide the following qualification for the treatment of electricity retail businesses, “although electricity retail businesses are not capital intensive and do not have long-lived assets, we apply the same target term-to-maturity of 10 years for consistency across industry sectors involved in the electricity and gas retail price review.”

The application of an IPART methodology based on consumer product type rather than the financial and economic fundamentals of a benchmark entity would be inappropriate. The discretionary application of methodology changes, such as the 10 year TOM to some sectors and not others, increases the likelihood that rating agencies and financiers alter their risk assessment of regulatory pricing risk. This would disadvantage all businesses regulated by IPART.

The Draft Report draws upon advice from Professor Kevin Davis, recommending ‘matching the term-to-maturity to a regulatory period, because this is consistent with the NPV neutrality of regulated cash flows under a building block model’. The relevance of NPV neutrality under the proposed IPART methodology is somewhat lost or weakened once trailing averages are
introduced into the overall regulated return calculation, under the proposed methodology changes. This is because the trailing average does not represent the best estimate of the cost that will be incurred by the regulated business over the period. Therefore NPV neutrality cannot be achieve under the proposed methodology. The best estimate of course is the current rate the rate at which businesses can actually borrow.

It is for these reasons that SDP urges IPART to apply this justifiable and important development to the WACC equitably across all businesses.

Of the submissions received on the IPART WACC Methodology Interim Report (Interim Report) dated 17 June 2013, all respondents supported the need to match the 10 year averaging period to a 10 year term-to-maturity. SDP requests IPART reconsider the valid arguments proposed by those submissions. In the case of businesses that have traditionally hedged their debt, the use of long term averages increases the complexity of hedging its cost of debt. Using a 10 year average of 5 year debt would make it impossible to effectively hedge without significant premiums being paid.

**Market-to-asset (MAR) comment as set out on page 39 and 40**

The Draft Report states that IPART will look to MAR to evaluate the resulting regulated return. The Draft Report states than an MAR of less than 1 suggests the regulator may have set returns too low relative to the true cost of capital.

The Draft Report uses as an example the $2.3bn long term lease of Sydney’s desalination plant. IPART have calculated the MAR on this transaction as being greater than 1. SDP urges that care is taken when using such high level metrics. A weakness in applying the MAR to regulated businesses arises due to the likely dislocation between the timing of a five yearly tariff reset by IPART and the timing of a sale or lease transaction. The weakness is that WACC components at a point in time (tariff setting process) will change in line with market forces and expectations over a five year period during which a sale or lease may occur. A future transaction price will be a function of the WACC at that future time. In the case of the lease of Sydney’s desalination plant, the time between IPART setting the tariff in December 2011, the base rate moved down 25bps in that month and fell a further 75bps by early June 2012. By August 2013 the base rate had fallen by another 100bps. Such an easing of monetary policy will have had a significant impact on the WACC calculated at the time of the bids, compared to the WACC when the tariff was set.

To some extent, the sale of regulated businesses with WACCs fixed for a period of time are analogous to fixed coupon rate bonds that are continually re-priced to the prevailing interest rates.