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Review of our WACC Method

Independent Pricing and Regyulatory Tribunal

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By website: www.ipart.nsw.gov.au/Home/Consumer_Information/Lodge_a_submission

16 August, 2017

Dear IPART,

Re: IPART WACC Review submission

Thank you for the opportunity to comment on the WACC methodology used by IPART.

ARTC hold voluntary access undertakings with the Australian Competition and Consumer Commission for both its Interstate and Hunter Valley Coal Networks. Some of its assets in NSW remain subject to IPART coverage; whilst formally all of the assets covered by the voluntary ACCC undertakings remain covered by state legislation and regulation should those ACCC undertakings lapse for any reason. ARTC therefore has a detailed understanding of the variability in WACC methodology across all the economic regulators in operation in Australia.

The variability in WACC methodology highlighted by IPART in its Issues Paper is a concern to ARTC which firmly believes that the IPART methodology provides the most reasonable and accurate reflection of WACC based on the concepts of stability, consistency and transparency. In particular ARTC considers the IPART approaches below as critical in reaching this conclusion:

- the publishing bi-annual updates of its WACC calculations has significant value in assisting its understanding of the status of that calculation;

- the underpinning methodology which IPART utilizes in developing its parameter assumptions removes significant volatility in the WACC calculation. For instance, its balance between short and long term assessments of market based parameters ensures short term market fluctuation. This ensures the WACC calculation applied is not the outcome of a temporal lottery, but more reasonably reflects changes in the parameters over time; and

- There is a consistency in the parameter logics and their interaction which is not present in all regulatory decisions. For instance, the use of a long term geometric average for inflation is logical when compared to a risk free rate assessed using a balance of on the day and historical forecasting term assessments. This avoids the inherent contradiction in using a long term inflation forecast on the assumption investors discriminate between short and long term expectations and require stable, long term forecasts whilst calculating a cost of equity based

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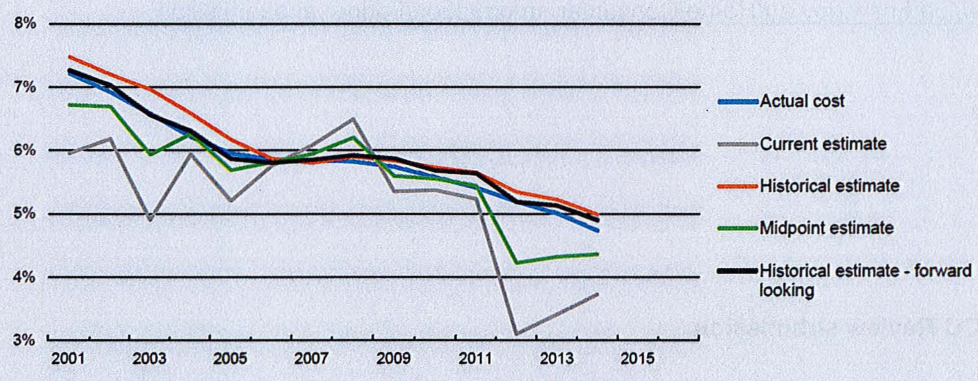
on the market risk free rate which imports both market volatility and the short term expectations excluded in the underlying forecasts. This inconsistency of market and long term parameter forecasts can provide perverse outcomes such as negative real interests despite the real interest rate instruments trading at positive rates when the short and long term expectations are drastically out of alignment.

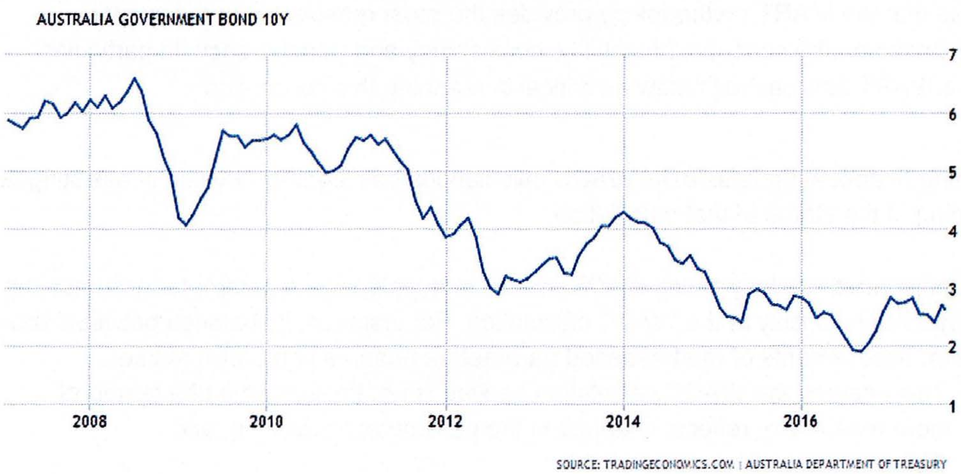
There are a number of critical points which are highlighted highlighted in Figure 4.2 of the Issues paper, reproduced below:

Figure 4.2 Risk-free rate: actual costs vs costs estimated using different approaches over a 3-year regulatory period[a]



a Firm is assumed not to hedge interest rate risk.
Data source: IPART analysis

This chart highlights that sharp reductions in the market rate drive the largest variances from the actual rate, which are offset to a significant degree by the use of the midpoint method. An historical analysis of the 10YB rate over the last 10 years highlights the importance of smoothing these volatility risks, as the low point reflected in Figure 4.2, is still higher than the market rate today and substantially higher than the historic lows of July 2016.



Given this decline in rate yet increase in volatility, developing a WACC methodology which smooths those impacts over time to provide a stable and transparent outcome, adequately reflecting the realities of changes in the cost of equity driven by changes in the market, is critical.

The outcome represented in Figure 4.2 whereby the addition of forward estimates improved the accuracy, does suggest an improvement to the IPART methodology which is to balance the short term market forecasts with a forward looking estimate of the rate based on available data. This will ensure that the risk free rate, and the consequent returns on debt and equity will reflect a historical requirement, the current realities of the market and the expectation of where rates will go in the future. Investment decisions are a function of all three of these temporal dimensions, so incorporating a forward looking dimension into the WACC calculation would improve its robustness and accuracy.

Aside from the adoption of a forward looking aspect in the WACC calculation, ARTC has no other suggestions for IPART to change its WACC methodology given the significant value derived from its current approach in stability, logical consistency and transparency.

If you have any questions in respect of this submission, please don't hesitate to contact me on [redacted].

I would be happy to discuss this submission further and in more detail if required and can be contacted on [redacted].

Yours Sincerely,

[redacted]

Jonathan Teubner

Manager, Economic Regulatory Development