5 July 2019

Mike Smart
Chief Economist
Independent Pricing and Regulatory Tribunal
mike_smart@ipart.nsw.gov.au

Dear Mike

ESTIMATING EQUITY BETA

Hunter Water welcomes the opportunity to comment on IPART's Fact Sheet: Estimating Equity Beta, as published on 1 April 2019.

Hunter Water supports IPART's work to develop and refine its weighted average cost of capital methodology, starting with the 2013 WACC review. IPART has developed and published an equity beta estimation method, delivering on a commitment made in the 2017-18 WACC review.

Hunter Water argued for and was supportive of IPART's decision to prepare estimates of the equity beta for water utilities using a broad comparator set of feasible comparator firms. We also emphasised the importance of using historic data to assess and identify any movements in actual equity beta estimates against longer term trends.

IPART's 2018 WACC method

IPART's 2018 WACC review advanced a number of principles for reviews of the WACC method and individual parameters.[1] We consider that these principles provide a robust foundation for all of IPART's work in this area:

- As reasonably accurate as possible: customers should not pay more than necessary and regulated firms should have the incentive to invest in the efficient level of productive assets.

- Stable over time: WACC method should give stakeholders certainty

- Predictable and replicable: provide transparency and reduce resources required in each price review.

- Incremental improvements through time: where there is sufficient evidence that they increase the accuracy of the cost of capital faced by the benchmark firm.

---

[1] IPART 2018, *Review of our WACC method, Final Report*, February, page 14.

IPART's 2018 Final Report recognised that regulatory stability in the WACC method, within and between regulatory periods, provides certainty to regulated firms and their customers. This is reflected in relatively stable returns for regulated firms and relatively stable prices for customers in the NSW metropolitan water sector.

Moody's Investor Services, our current credit rating agency, has commented favourably in recent years on IPART's approach, noting the "stable and mature regulatory framework" and the consistency in IPART's decision making resulting in "increased stability in revenue outcomes for Hunter Water". Moody's assessment of Hunter Water's relative financial position has improved as a result of the transparency and integrity of IPART's WACC reviews.

The final report for the 2018 WACC method set out IPART's process for reviewing the equity beta for future price reviews:[2]

> *We acknowledge stakeholders' concerns that the equity beta should only be changed in the response to significant evidence, in order to maintain certainty. Therefore we have decided to review the equity beta at each price review (currently every 4-5 years), but only change it when there is sufficient evidence that our existing estimate is no longer appropriate.*

Hunter Water supported IPART's 2018 final decision to inform its decision making on setting an equity beta value by estimating equity betas using actual data for comparable stocks. We agreed with IPART's decision to improve the proxy selection process by making it transparent, predictable and replicable.

IPART's 2019 Fact Sheet – Estimating Equity Beta

IPART's 2019 Fact Sheet re-iterates the approach to setting the equity beta at each price review:[3]

> *We are asking stakeholders to comment on a new method of using market data to estimate the equity beta. We intend to consider these estimates, along with other evidence on beta, as an input to our decisions on beta in future price reviews.*

IPART's periodic estimates of the equity beta for listed equities would help inform WACC decisions at each price review:

> *We would then consider the median beta value in the context of other evidence on beta, including other regulatory decisions. In doing so, we would have regard to submissions from stakeholders.*

IPART's 2019 Fact Sheet, Estimating Equity Beta, gives effect to the commitments made in the 2018 WACC method review. IPART sets out a process for selecting firms, screening rules, and data quality and liquidity filters. IPART starts with 228 publicly traded firms from various international equity markets. After applying screening tests and filters, IPART's estimation process results in a median equity beta value of 0.74 from a sub-set of 35 firms.

---

[2] IPART 2018, *Review of our WACC method, Final Report*, February, page 61.

[3] IPART 2019, *Estimating Equity Beta, Fact Sheet*, April, page 1.

Hunter Water's 2019 Price Submission uses an equity beta value of 0.7 for calculating a proposed WACC estimate of 4.1%. We reference the work undertaken by IPART in developing a process to select proxy companies and estimating empirical values, and the 0.74 value applied by IPART in the Essential Water and Central Coast Council pricing decisions in May 2019.

We acknowledge the good work undertaken by IPART – in particular:

- Documenting key steps in the process, the various filters and source code

- Publishing the final set of comparator firms and the results for individual companies

- Identifying areas for future development, including supplementary data sources, other industry classification schemes and formalising post-screening tests.

Hunter Water was comfortable with IPART's equity beta estimate of 0.74. We have not interrogated IPART's method, filters or source code. We have not reviewed the finance literature on issues associated with empirically measuring equity beta values using actual market data, or the statistical limits and shortcomings of alternative approaches.

IPART's equity beta estimate sits at the mid-point of IPART's equity beta values. It is consistent with past IPART decisions and those of other Australian economic regulators when setting WACC estimates for the water sector.

IPART decision-making for future price reviews

Hunter Water welcomes IPART's ongoing efforts to improve and refine the WACC method and specific WACC parameters. We welcome and support IPART's development of an analytical process for estimating equity beta values. Importantly, IPART states that it would *"have regard to the equity beta estimated with this method "along with other evidence on beta in our future WACC decisions".*

Hunter Water understands that there are a number of areas where IPART could further develop the framework and process for selecting and screening proxy companies. These include:

- Broadening the sample to include comparator firms using other data sets – in addition to the Thompson Reuters Business Classification

- Assessing the impact of extending the period for trading data beyond 36 months, to see whether it produces more stable estimates

- Assessing the practicality of calculating weekly rather than monthly returns

- Undertaking a sensitivity test using a broader sample (possibly including Australian infrastructure companies and excluded international markets), to see whether it produces more stable estimates.

Hunter Water recognises that IPART would invite comment from regulated utilities if the estimation process calculating an equity beta that differed materially from the 0.7 value. Given the importance of the equity beta value for our regulated revenues and financial metrics, we would engage specialist corporate finance advisors to undertake a review of IPART's approach in those circumstances

Summary

We support IPART's WACC method and periodic WACC reviews, underpinned by the principles of accuracy, stability and replicability. We understand that IPART would apply expert regulatory judgement, incorporating multiple sources of evidence, before making any decision to depart from a mid-point equity beta estimate.

IPART has developed a sophisticated and useful tool to sample comparator firms as one of multiple inputs to future WACC decisions. We understand that IPART will use these results to help inform WACC decisions, not as a mechanistic or deterministic process for calculating exact values.

Yours sincerely

Peter Shields
Head of Economics