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Dr Paul Paterson
Independent Pricing and Regulatory Tribunal (IPART)
PO Box K35
Haymarket Post Shop NSW 1240

Submission on Issues Papers regarding IPART's Metro Water Price Reviews

Dear Dr Paterson,

Thank you for the opportunity to provide Sydney Desalination Plant Pty Limited's (SDP's) views on IPART's Issues Papers in relation to the review of prices for Sydney Water Corporation, WaterNSW Greater Sydney and Hunter Water Corporation (the Metro Water Price Reviews).

This submission focuses on just one issue on which IPART has sought comment on in its Issues Papers, namely: should IPART update prices annually to reflect annual changes in the trailing average cost of debt allowance, or should changes in the cost of debt allowance be passed through via a true-up in the subsequent regulatory period?

The three businesses that are the subject of the Metro Water Price Reviews each took a different approach to this question:

- Sydney Water proposed the use of a true-up approach;
- WaterNSW proposed annual price updates; and
- Hunter Water expressed no preference between the two approaches.

However, IPART has proposed in its Issues Paper to apply the same approach to all three businesses.

As we explain in this submission, this one-size-fits-all approach is inconsistent with the approach set out in IPART's 2018 WACC methodology decision.

We urge IPART to adhere to the 2018 WACC methodology decision, which indicated that IPART would choose between "annual price adjustments or a true-up on a case-by-case basis" rather than treat either option as the "default."

The 2018 WACC methodology decision

During IPART's 2017-18 WACC methodology review, SDP supported the adoption of a trailing average approach to setting the cost of debt allowance on the grounds that it would allow regulated businesses to match their actual cost of debt to the regulatory allowance without incurring imprudent refinancing risks.

In its Final 2018 WACC methodology decision, IPART agreed with SDP and noted that:[1]

> *We have considered stakeholders' analysis and decided to change our approach. Because our 2013 method does not update the historic cost of debt within a regulatory period, it implicitly assumes that debt maturing within the period is refinanced at historic costs rather than prevailing interest rates. In general, this means firms are not able to match the cost of debt maturing within a regulatory period with the cost of new debt issuance. As a result, our 2013 method can create refinancing risks for firms on the portion of their debt that is maturing during the regulatory period.*
>
> *We also accept that because a trailing average approach updates the historic cost of debt annually within a regulatory period, it assumes that maturing debt is refinanced at prevailing interest rates. This increases accuracy and reduces refinancing risks for firms.*

Subsequently, in its pricing decision for the Murray River to Broken Hill Pipeline, IPART reiterated that the trailing average approach allows businesses to better manage their refinancing risks:[2]

> *In our view, a trailing average cost of debt allows regulated businesses to better manage their refinancing risk, while maintaining their incentives for efficient investment.*

As IPART accepted in the 2018 WACC methodology decision, the trailing average reduces refinancing risks for firms because "a trailing average approach **updates the historic cost of debt annually within a regulatory period**" (emphasis added).

Indeed, precisely for this reason, other regulators that have adopted the trailing average approach—including the Australian Energy Regulator (AER), the Economic Regulation Authority of Western Australia and the Essential Services Commission in Victoria—update the cost of debt allowance annually. Annual updating of prices is well accepted regulatory practice when implementing the trailing average approach.

However, during the 2018 WACC methodology review, some businesses proposed that the annual changes in the trailing average cost of debt allowance should be accumulated within each regulatory period and passed through using a true-up mechanism in the next regulatory period. SDP understands that the main reason for this proposal was a concern about the potential increase in administrative costs that some businesses would face if they were required to update their prices annually, within the regulatory period.

IPART consulted on the use of a true-up mechanism in relation to the trailing average cost of debt allowance in its Draft WACC methodology decision. In response to that consultation, SDP provided the results from financial modelling that demonstrated the impact that a true-up mechanism can have on the cash flows and credit metrics of a benchmark business with SDP's characteristics.[3] SDP noted in its submission that:

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[1] IPART, Review of our WACC method, Final Report, February 2018, p. 27.

[2] IPART, Murray River to Broken Hill Pipeline, Final Report, May 2019, p. 59.

[3] SDP submission on IPART's Draft WACC methodology decision, 8 December 2017, p. 9.

- The cash flow mismatches arising from application of the true-up proposed by IPART cannot be hedged fully, so would expose a benchmark efficient entity to unnecessary financial risk;
- These cash flow mismatches could imperil the key financial metrics that determine the creditworthiness and future borrowing costs of SDP; and
- Larger regulated businesses, with diversified sources of non-regulated revenues and/or State government support may be better placed than SDP to manage such cash flow mismatches.

SDP proposed that:

- Any end of regulatory period true-up should be applied only to those firms that advocate, and are able to accommodate, such a true-up; and
- The implementation of any true-up should be confined to the firm advocating it and should not affect the regulatory arrangements of other businesses such as SDP that are less able to accommodate the cash flow timing risks associated with such a true-up mechanism.

In response to IPART's Draft WACC methodology, Sydney Water (SDP's direct customer) submitted that it would support an annual cost of debt allowance pass-through for bulk water suppliers (including SDP), and noted that Sydney Water could accommodate this relatively simply by extending the existing pass-through arrangements for bulk water costs.[4]

IPART's Final WACC methodology decision appeared to largely accept SDP's proposals. Specifically, IPART stated that it would decide whether to apply a true-up or annual pass through of changes in the cost of debt allowance on a case-by-case basis:[5]

> *...we will decide whether to apply annual price adjustments or a true-up on a case-by-case basis, as part of our review process. In making this decision, we will have regard to any evidence the regulated firm or its customers put forward to support one approach or the other. Neither option would be a default.*

IPART recognised that some businesses had expressed a preference for a true-up approach:[6]

> *...Sydney Water submitted its strong preference for using a true-up to adjust prices. It stated that "the benefits to our customers of simple, transparent and stable bills for the entire regulatory period far outweighs any perceived small cumulative benefits of unidirectional changes in bills over the regulatory period".*

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[4] Sydney Water's submission to IPART's WACC review draft report 2017-18, 8 December 2017, p. 12.
[5] IPART, Review of our WACC method, Final Report, February 2018, p. 38.
[6] IPART, Review of our WACC method, Final Report, February 2018, p. 38.

However, IPART also recognised that other businesses had expressed valid concerns that a true-up could impose financeability risks:[7]

> *...SDP noted that while a firm was waiting to receive a true-up in its favour in several years' time, it could potentially breach its debt covenants, which often specify financial ratios that must be met in each year. While the eventual receipt of the true-up would theoretically overcome the problem, it might not be timely from the lenders' point of view.*

In its recent Issues Papers, IPART notes that the true-up approach would be implemented in a "NPV-neutral" way.[8] This means that the cost of debt allowances to a regulated business using the true-up approach and the annual updating approach would be equivalent in NPV terms. However, the timing of cash flows under the two approaches would not be equivalent. As recognised in the quote above, mismatches in the timing of cash inflows (regulated revenues) and outflows (debt service obligations) under the true-up approach could create financeability problems for individual businesses.

IPART went on to provide the following assurance in the 2018 WACC methodology decision:[9]

> *We can see merit in both points of view. The different perspectives reflect the different circumstances of each organisation. For this reason, we have decided not to impose a uniform rule on all regulated firms. Instead, we will decide whether to apply annual price adjustments or the true-up on a case-by-case basis, as part of our review process. In reaching this decision, we will consider any submissions from the regulated business, its customers and other relevant stakeholders. Neither option would be considered the default.*

SDP was heartened by IPART's assurance that it would take a case-by-case approach to assessing whether changes in the cost of debt allowance should be passed through via annual updating of regulated prices or through a true-up. That assurance indicated that IPART had taken seriously submissions from different stakeholders and recognised that a flexible approach to this issue that would accommodate the specific circumstances of individual regulated businesses would be the best way forward.

Reasoning provided in the Issues Papers

In the Metro Price Reviews Issues Papers, rather than adopting a case-by-case approach as indicated in the 2018 WACC methodology decision, IPART appears to have imposed the uniform approach of a true-up on all the businesses, regardless of their particular circumstances.

IPART indicates that its key reason for preferring the true-up approach is that the true-up approach provides price certainty to customers over the regulatory period. Specifically, IPART states the following:[10]

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[7] IPART, Review of our WACC method, Final Report, February 2018, p. 38.

[8] IPART, Review of prices for WaterNSW Greater Sydney, Issues Paper, September 2019, p. 48.

[9] IPART, Review of our WACC method, Final Report, February 2018, p. 39.

We prefer the option of applying a regulatory true-up at the subsequent determination period because it provides certainty to customers about their prices over the upcoming determination period.

As noted above, price stability was the key benefit cited by supporters of the true-up approach during the 2017-18 WACC methodology review. However, SDP points out that IPART itself has acknowledged that annual price changes for end use customers under a trailing average approach are unlikely to be large. This point is discussed in further detail below. The financial impact for an efficient benchmark business like SDP on the other hand could be significant.

Furthermore, as WaterNSW explained in its Metro Water Pricing Review proposal to IPART, annual updates to prices for inflation and other price inputs are commonplace—including under IPART's regulatory framework. The annual updating of prices to accommodate changes in the cost of debt allowance is, in principle, no different to applying annual adjustments to prices to reflect inflation. If price stability is such an overriding consideration, it is unclear to SDP why IPART does not also do away with annual adjustments for inflation. To the extent that it is efficient for consumers to be exposed to annual price changes that reflect inflation, it is also efficient for consumers to be exposed to changes in price changes that reflect changes in the cost of debt allowance.

SDP notes that consumer representatives have expressed support for the annual updating approach. For example, during the AER's 2018 review of its rate of return guideline, the Consumer Challenge Panel (a group of experts convened by the AER to advise on the whether the regulated networks' proposals are in the long-term interests of consumers) submitted that:[11]

...we continue to support...continuation of the AER's overall approach of a 10-year trailing average ***with annual updates*** *and a transition period.* (emphasis added)

SDP also submits that end-users of SDP's services (i.e., water users in Sydney) are already familiar with annual updating of regulated prices to reflect changes in the regulated cost of debt allowances. This is because end-users of SDP's services are also consumers of electricity and gas services supplied by network businesses regulated by the AER, who are subject to trailing average cost of debt allowances implemented through the annual updating of regulated revenues.

The main concern that SDP and others expressed about the true-up approach was that it could create unnecessary and avoidable cash flow mismatches that could undermine the financeability of some businesses. As noted above, the concerns about the true-up approach were evidenced by modelling analysis that demonstrated the possible deterioration of SDP's

[10] IPART, Review of prices for WaterNSW Greater Sydney, Issues Paper, September 2019, p. 48.

[11] Consumer Challenge Panel, Submission to the AER on its Allowed Rate of Return on Debt Discussion Paper, 30 May 2018, p. 10.

financeability under such an approach. As IPART acknowledges, financeability concerns related to the true-up approach was one of the reasons cited by WaterNSW in favour of an annual updating approach:[12, 13]

> *WaterNSW states that without annual updates the cashflow impact of differences between the cost of debt allowance and the actual interest costs are borne by the firm and may impact on credit ratings. It claims that this may impact the financeability of the firm.*

In the 2018 WACC methodology decision, IPART acknowledged that there were opposing points of view about the appropriateness and consequences of the true-up and annual updating approaches, and that there was merit in these opposing points of view. Therefore, IPART decided that it would choose between annual price adjustments and a true-up approach on a case-by-case basis rather than impose a uniform approach on all regulated firms.

However, despite a commitment to use a case-by-case approach, IPART has used the true-up approach in three pricing decisions since the publication of the 2018 WACC methodology,[14] despite some of the regulated businesses involved in those price reviews proposing an annual updating approach, in part to deal with financeability concerns. In addition, IPART has indicated a preference to apply a true-up approach in all of the Metro Water Price Reviews, despite WaterNSW's explicit concern that the imposition of a true-up approach might impact adversely the financeability of the firm.

In no price review since the publication of the 2018 WACC methodology decision has IPART actually applied, or indicated an intention to apply, the annual updating approach.

Given this, SDP is concerned that despite the assurances provided in the 2018 WACC methodology decision, IPART *is* imposing a uniform rule on all businesses rather than following a case-by-case approach, and that the true-up approach *is* becoming IPART's default option, regardless of the specific circumstances of individual businesses. SDP submits that the one-size-fits-all approach that IPART has adopted in every decision since February 2018 is incompatible with the 2018 WACC methodology.

IPART explains in its Issues Paper for WaterNSW that the application of a true-up approach would avoid volatility in prices due to large changes in the cost of debt:[15]

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[12] IPART, Review of prices for WaterNSW Greater Sydney, Issues Paper, September 2019, p. 46.
[13] WaterNSW cited a number other valid reasons to favour annual updating, including following: annual updating of the cost of debt allowances reduces the likelihood of large price shocks to customers from one regulatory period to the next; an annual updating approach aligns well with an efficient and prudent debt management strategy so incentivises businesses to incur efficient debt raising costs; and an annual updating approach is administratively simple because it is standard practice for regulated businesses to update prices annually (e.g., in line with changes in inflation).
[14] These decisions, all finalised in May 2019, were: the WaterNSW Murray River to Broken Hill Pipeline Price Review; Essential Water Price Review; and the Central Coast Council Price Review.
[15] IPART, Review of prices for WaterNSW Greater Sydney, Issues Paper, September 2019, p. 48.

...if we applied an annual update, a large change in the cost of debt would flow through to customer prices in the following year of the determination period, unless additional side constraints were imposed in the determination.

This statement contradicts directly IPART's stated view in the 2018 WACC methodology decision that annual changes in the cost of debt allowance under a trailing average approach are likely to be small. For example, IPART explained in the 2018 WACC methodology decision that:[16]

The annual changes in this cost during the period under a 10-year trailing average approach are likely to be small because the cost of debt is recalculated for only 5% of the benchmark firm's total debt each year.

And that:[17]

Each year, the change in the historic estimate will be added to the change in the current estimate. Depending on the length of the regulatory period, in total, about 15-20% of the firm's debt would reprice each year under our 2018 method.

SDP supports the conclusion that IPART reached in the 2018 WACC methodology decision that annual price changes under IPART's new trailing average approach "are likely to be small." Large year-on-year changes in the prevailing cost of debt market would not flow fully into the cost of debt allowance, since the prevailing cost of debt in any given year represents only a small fraction of the overall cost of debt allowance in that year.

Given that annual price changes are likely to be small under a trailing average approach, the benefits of price stability under the true-up approach relative to the annual updating approach appear to be greatly overstated. However, as the modelling that SDP has already provided to IPART shows, the true-up approach may result in significant cash flow mismatches that no efficient business in SDP's position can hedge or mitigate fully. That is, the modest benefits of slightly more stable prices within each regulatory period may only be achieved by imposing a material cost (in the form of a deterioration in financeability) on some businesses. That cost could not be managed by privately-financed businesses such as SDP.

Summary of SDP's position

In summary, SDP notes that:

- The trailing average cost of debt approach adopted by IPART in the 2018 WACC methodology decision requires the cost of debt allowance to be updated each year. It is this process of annual updating that allows efficient and prudent regulated businesses to match their actual cost of debt as closely as possible to the regulatory allowance.

[16] IPART, Review of our WACC method, Final Report, February 2018, p. 27.
[17] IPART, Review of our WACC method, Final Report, February 2018, footnote 53, p. 27.

- During the 2018 WACC methodology review, some businesses strongly supported an approach that would allow changes in the trailing average cost of debt allowance to be passed through via annual updating of prices, so as to minimise financeablity problems arising from mismatches between the timing of regulated revenues and debt service obligations. Other businesses argued in favour of changes in the cost of debt allowance being passed through via a true-up mechanism in the subsequent regulatory period on the grounds that this would increase price stability within each regulatory period and minimise the administrative costs associated with businesses changing their prices annually.
- In the 2018 WACC methodology decision, IPART stated that it saw merit in both these points of view and, therefore, it would treat neither as the default option. Instead, IPART committed to choose between the annual updating approach and the true-up approach on a case-by-case basis, taking account of the specific circumstances of the business in question, and the submissions received from stakeholders.
- However, in every price review since the publication of the 2018 WACC methodology decision, IPART has opted for a true-up mechanism rather than the annual updating of prices—even when the business involved has submitted that a true-up approach may create financeability problems. It is unclear how IPART's uniform approach across decisions on this issue is consistent with an approach that reflects the circumstances of individual businesses.
- SDP is concerned that rather than applying a case-by-case approach, as was determined in the 2018 WACC methodology decision, IPART is imposing a uniform rule on all businesses, where the true-up approach is effectively the default option.

SDP commended IPART's 2018 WACC methodology decision because it seemed to provide clarity and certainty about how IPART would approach the task of setting WACC allowances in coming price reviews. This is particularly important to a business such as SDP that relies on private finance rather than government finance to deliver the services that end consumers value, since private investors value regulatory certainty and predictability. However, certainty and confidence in the regulatory arrangements would be undermined significantly if IPART fails to adhere to the 2018 WACC methodology decision.

Therefore, SDP urges IPART to reconsider its approach on this matter. IPART should adhere to its commitment in the 2018 WACC methodology decision to apply a case-by-case approach to choosing between the annual updating and true-up approaches by taking into account the circumstances of individual businesses. This means that IPART should give more serious consideration to businesses' concerns that a true-up approach could impose financeability risks than it has done to date.

SDP would be pleased to engage with IPART further, should you wish to discuss or clarify any aspect of our submission.

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