NSW GOVERNMENT | Treasury

Contact: Jim Dawson
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Dr Boxall
Chairman
Independent Pricing and Regulatory Tribunal
PO Box K35
Haymarket Post Shop NSW 1240

Dear Dr Boxall,

Response to request for submissions on IPART's Draft Report, "Review of our WACC method"

NSW Treasury is the owner of a number of regulated utilities that are subject to IPART's oversight and will be affected by any changes to your WACC methodology. These utilities are

- Sydney Water Corporation
- WaterNSW
- Hunter Water Corporation
- Essential Water

This submission (see attachment) addresses the most pressing issue to the State raised in IPART's consultation paper and draft report. NSW Treasury strongly recommends a change to the cost of debt calculation to a 100% 10-year trailing average approach, i.e. using historical averages that are updated periodically during the determination period. NSW Treasury views this approach as reflective of efficient debt management practices and indicative of what a benchmark entity in a competitive environment would follow.

NSW Treasury is supportive of the submissions from the state owned utilities and will rely on them to present their views on points not raised in this letter. NSW Treasury welcomes the opportunity to provide its view on the IPART draft report and looks forward to continuing to work collaboratively with IPART on regulation in the future.

Yours sincerely,

[redacted]

Jim Dawson

Executive Director – Commercial Assets
NSW Treasury

Cost of Debt

Treasury's Recommendation

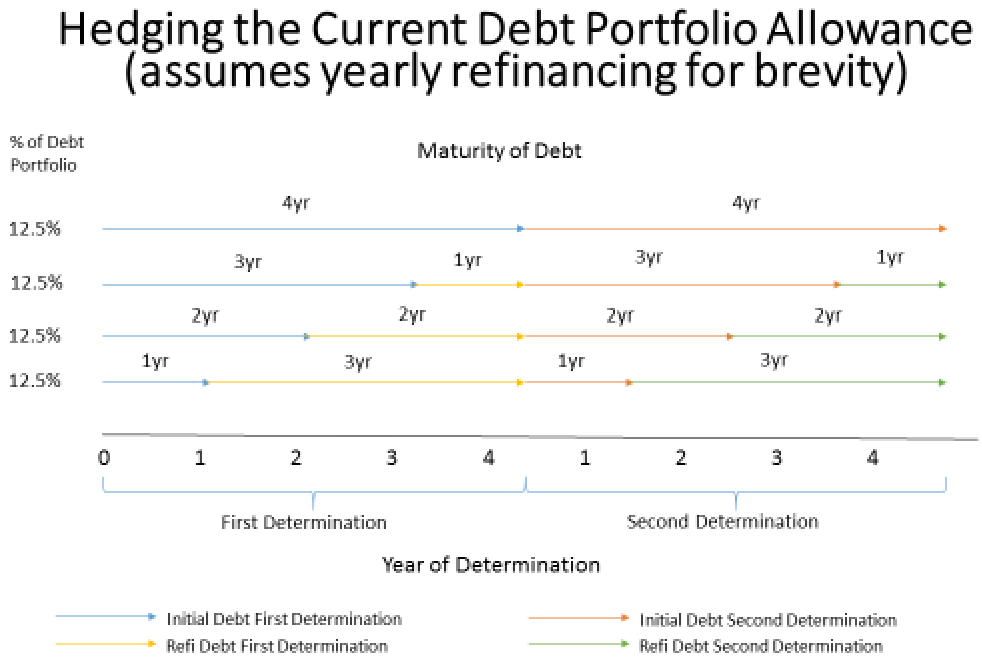
NSW Treasury (Treasury) maintains its strong recommendation that the cost of debt be based solely on a 10 year trailing average methodology. As discussed in our previous submission, in the absence of regulation, a staggered maturity debt portfolio is consistent with an efficient debt financing and risk management strategy. Asset-Liability management suggests that debt portfolio characteristics should be matched as close as possible to the characteristics of the utilities' assets. The assets of the utilities are long life assets, for instance Sydney Water's average asset life is 40+ years. A long maturity, trailing average methodology would be best placed to replicate the maturity profile of the regulated assets. In Cambridge Economic Policy Associates' (CEPA) 2016 study commissioned by Ofwat (UK Water Regulator) and the Civil Aviation Authority (CAA), CEPA proposed to Ofwat to use a 20 year trailing average. Other international regulators and domestic regulators have adopted a 10 year or longer trailing average including Ofgem, ORR, AER, ESCOSA and ESCV. Treasury recommends using a 10 year trailing average in light of the corporate debt market in Australia.

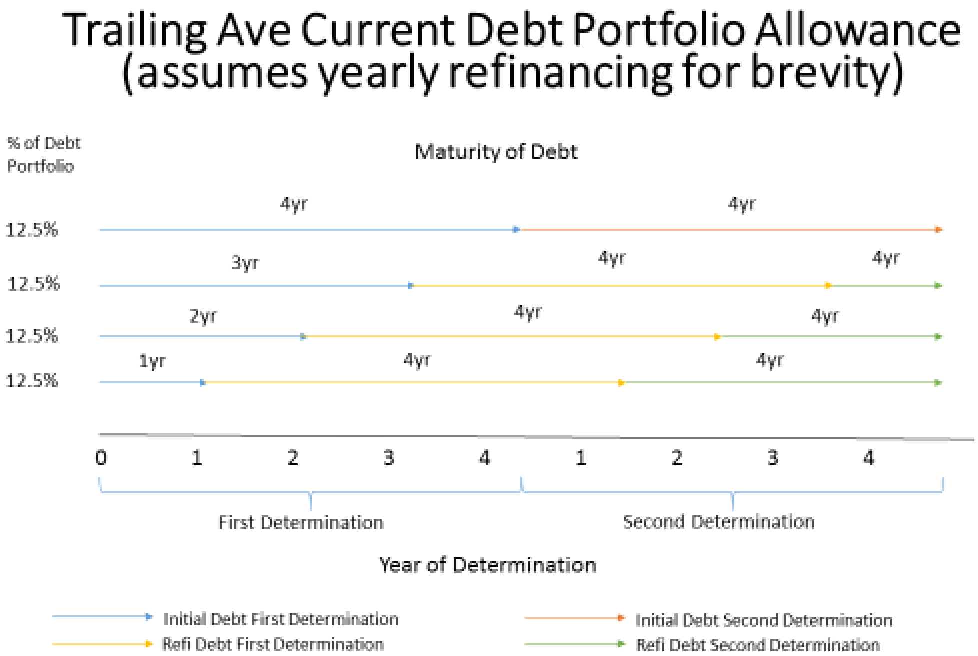
In order to prevent a one-off windfall gain given that the 10 year trailing average yield is higher than current market rates, Treasury would support a transition to the trailing average for the portion of the debt that is estimated using IPART's current cost of debt calculation. At the start of a determination, the Historical Average approach for IPART's long term cost of debt estimate would already be aligned to the 10 year trailing average and would not need a transition. Treasury would also recommend that the cost of debt in the trailing average approach is updated annually to reflect assumed borrowing and maturities during the determination period. Annual updates would prevent large price changes between determination periods.

IPART's Draft Proposal

IPART has proposed that the cost of debt for the next determination be calculated using the current methodology, i.e. an average of IPART's estimates of the current cost of debt and the historical cost of debt. IPART then assumes that the portion of debt relating to the current cost of debt is refinanced evenly through the determination period. The difference in interest expense between the current cost of debt and the actual cost of debt for each portion of debt that is refinanced during the determination is compounded to the end of the determination. The compounded differences form a true-up amount to be included in the next determination. For the next determination, the process repeats.

In order to effectively hedge the current cost of debt allowance, the utility would have to issue all the debt related to the current cost of debt allowance (50% of total debt portfolio) during the 40 day averaging period prior to each determination. A pro-rata portion of this debt would mature at each month-end of the determination period. This maturing debt would then need to be refinanced into debt that matured at the end of the determination period. The process would then repeat with all the debt related to the current cost of debt (50% of total debt portfolio) being refinanced. The new proposal increases the refinancing burden instead of reducing this burden as IPART suggest in their draft report. In addition, debt raising costs would rise as a result of increased refinancing. Please see the illustration below.





Treasury would prefer to see the cost of debt calculation based solely on a 10yr trailing average for the reasons given above and in Treasury's original submission. However, to the extent IPART would prefer to include a weighting to their current cost of debt estimate, Treasury would recommend using a 4yr trailing average rather than the proposed method. Please compare the illustration of the 4yr trailing average above to IPART's proposal to see the difference in refinancing burden.

Treasury would ask IPART to reconsider their proposal.