



Hunter Water Corporation
ABN 46 228 513 446

Office of the Managing Director

PO Box 5171
HRMC NSW 2310
36 Honeysuckle Drive
NEWCASTLE NSW 2300
(02) 4979 9521 (T)
(02) 4925 2078 (F)
kim.wood@hunterwater.com.au

26 July 2013

Our Ref: HW2011-1100/3

Mr James Cox PSM
Chief Executive Officer and Full Time Member
Independent Pricing and Regulatory Tribunal of New South Wales
PO Box Q290
QVB Post Office NSW 1230

Dear Jim

SUBMISSION ON INTERIM REPORT ON WACC METHODOLOGY

Hunter Water welcomes the continuation of the review by IPART on the methodology for determining the weighted average cost of capital (WACC) due to the significant impact the WACC can have on both consumers and also utilities. Hunter Water's key concern continues to be focussed predominantly on the needs of consumers.

Hunter Water is concerned if the intent of this Interim Report is to serve as anything other than a formalisation of the interim approach taken by IPART in determining the WACC outcome for the recent price determinations (including that of Hunter Water). As noted in previous submissions by Hunter Water, Sydney Water and Sydney Catchment Authority, support for the use of a combination of "short-short" and "long-long" averages in determining the WACC was predicated on this approach being used only as an interim or transitional measure until a more robust, predictable and transparent long-term approach could be finalised.

As previously submitted, if an appropriate WACC is not applied in the pricing methodology then the interest of consumers may not be met. If the WACC is set too high then the objective of price regulation is not met as utilities are overcompensated for their costs. Conversely, if the WACC is set too low then the objective of price regulation is similarly not met as utilities face the risk of being financially unsustainable which could impact on future investment by the utility and may result in the utility being unable to provide services to its customers.

Hunter Water continues to support the use of long-term trailing averages in determining the appropriate cost of debt in the determination of the WACC as this would simplify the risks facing both utilities and consumers and ensure that debt WACC parameters and actual debt costs would be more aligned, avoiding both over-compensation and under-investment for consumers. This approach is consistent with that recently taken by Ofgem in the United Kingdom.

Hunter Water's comments on the Interim Report on the WACC methodology are provided below. The underlying premise of the comments relates to the broader principles of the approach to setting the WACC needing to be consistent with the broader principles of regulation, that is be "...transparent, predictable, consistently applied over time and between utilities, (and) no more complex than necessary".¹

¹ IPART, 2012, *Review of method for determining the WACC. Dealing with uncertainty and changing market conditions*. Other Industries - Discussion Paper, Sydney, December, p13

Regulatory Objective

Hunter Water considers that the removal of the "new entrant" test from the regulatory objective as originally stated in the Discussion Paper is a clear improvement. However, there is an inherent inconsistency with the regulatory objective as compared to the decisions made with regard to the determination of market-based WACC parameters.

The regulatory objective for setting the WACC is stated as being "...to set an efficient product price for a benchmark firm operating in a competitive market and facing similar risks".² However IPART note their intention to continue to have regard to the regulatory period for water businesses in determining the estimated cost of capital in the WACC and as such, their intention to continue to use a five-year term-to-maturity in determination of the risk-free rate.

It is Hunter Water's position that the use of a five-year term-to-maturity is inconsistent with the objective of a firm operating in a *competitive* market. As such, Hunter Water submits that, consistent with the approach taken in the recent electricity price determination³, a ten-year term-to-maturity should be applied. As noted by IPART, a ten-year term-to-maturity reflects "...the expected life of the assets and financing practices of **competitive** businesses with long-lived assets".⁴

Hunter Water is firmly of the belief that the use of a ten-year term-to-maturity is most appropriate for any business with long-lived assets, irrespective of the regulatory period that may be applied. If a ten-year average of a ten-year term-to-maturity bond is taken, this would at least provide some ability for a business to hedge debt costs. In contrast, the current (and proposed) approach of taking a ten-year average of a five-year term-to-maturity bond and resetting this every four years is impossible for a business to hedge.

In addition, moving to a consistent ten-year term-to-maturity would align with the broader principles of the approach to setting the WACC needing to be consistent with the broader principles of regulation, that is be "...transparent, predictable, consistently applied over time and between utilities, (and) no more complex than necessary".⁵

Establishing a WACC Range

IPART's interim decision is to establish a WACC range using the mid-points of the WACC ranges estimated using current market data and long-term averages. Although Hunter Water supported the use of such an approach as a transitional or interim measure, it does not support this approach being applied in the longer-term.

Hunter Water strongly believes that the ultimate decision on the WACC methodology must provide a more robust, predictable and transparent long-term approach. The approach proposed in the Interim Report whereby the ultimate decision on the WACC is selecting the mid-point of two mid-points is anything but robust or predictable.

As noted by Hunter Water in our submission on the Review of Method for Determining the WACC⁶ and as highlighted by the Productivity Commission⁷, financial market volatility can cause inequity between utility owners and between customer groups. The Interim Decision does not remove the impact of financial market variability, nor does it necessarily make the forecasting of a WACC any more predictable. The use of a methodology that exposes a regulatory determination to financial market volatility continues to result in a WACC decision that is contrary to the expectations of consumers and regulated businesses in relation to price and revenue stability.

² IPART, 2013, *WACC Methodology. Research - Interim Report*, Sydney, June

³ IPART, 2013, *Review of regulated electricity retail prices 2013 to 2016*, Sydney, June

⁴ IPART, 2013, *WACC Methodology. Research - Interim Report*, Sydney, June

⁵ IPART, 2012, *Review of method for determining the WACC. Dealing with uncertainty and changing market conditions*. Other Industries - Discussion Paper, Sydney, December, p13

⁶ Hunter Water Corporation, 2013, *Response to IPART discussion paper - Review of method for determining the WACC*, Newcastle, March

⁷ Productivity Commission, 2012, *Electricity Network Regulatory Frameworks*, Melbourne, October

Further, we argue that if the range proposed in the interim methodology is narrow, then the selection of a mid-point is perhaps acceptable as being representative. However, if there is a greater variation in the range, the selection of a mid-point may not be the most appropriate. On this point, Hunter Water believes that the market conditions that existed at the time of the Final Determination for Hunter Water, being at near-record lows, resulted in an under-estimation of the WACC by taking the mid-point of a broad range.

Deviation from the mid-point

The interim report does not clearly clarify the criteria for when IPART would consider deviating from selecting the mid-point in their determination of WACC other than requiring "strong evidence" to support an alternative value. If there is any intention by IPART to continue to use this approach, clear and transparent criteria or principles will be required such that regulated businesses can understand how this may be applied.

Consistency

One final point that requires further discussion is the issue of consistency - consistency within the WACC parameters and also consistency between utilities (and between industries).

As raised in our original submission, Hunter Water proposes that long-term averages should be used in estimating all of the market-based parameters in the WACC (that is, the use of long-term trailing averages for the cost of debt and the use of long-term averages for the market risk premium). This approach would ensure there is internal consistency within the capital asset pricing model and will more accurately reflect the capital costs of a model utility with long-lived assets.

As previously noted, IPART's stated broad principles of regulation are an approach that is *"...transparent, predictable, consistently applied over time and between utilities, (and) no more complex than necessary"*.⁸ It is Hunter Water's position that the current approach and, indeed, recent decisions by IPART have not followed these principles, in particular with regard to consistency between utilities.

In determining the WACC for electricity⁹ there were several inconsistencies in the decision as compared to the other IPART determinations also published in May and June for the water industry. The inconsistencies included the use of a ten-year average of ten-year Commonwealth Government bonds (which diverges from IPART's standard approach of using five year term-to-maturity) and also the reduction in the assumed gearing ratio for electricity retail and electricity generation. Hunter Water's concerns regarding consistency in the term-to-maturity have been addressed previously in this letter.

With reference to the reduction in assumed gearing ratios, the reasoning provided in the determination was that it was to address concerns raised by electricity generators regarding the internal consistency of the WACC parameters whereby retailers submitted that the gearing ratio determined for electricity generation assumed in the 2010 determination was inconsistent with a credit rating assumption of BBB/BBB+.¹⁰

The inconsistency of this decision between the electricity sector and the water sector is of particular concern to Hunter Water as the recent determination by IPART for Hunter Water continues to assume a gearing ratio of 60% (well above that determined for electricity generation of 40%) and Hunter Water's internal modelling clearly indicates that with a gearing ratio of 60%, Hunter Water would be well below investment grade and certainly not rated at BBB/BBB+.

If the assumed gearing level of an efficient water utility is not reviewed in the near future, then Hunter Water may be in a situation where it has a credit rating below BBB and therefore faces debt costs that are different to those assumed for a utility rated at BBB/BBB+. If this occurs, it is likely to begin a cycle

⁸ IPART, 2012, *Review of method for determining the WACC. Dealing with uncertainty and changing market conditions*. Other Industries - Discussion Paper, Sydney, December, p13

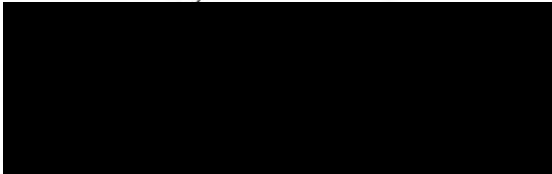
⁹ IPART, 2013, *Review of regulated electricity retail prices 2013 to 2016*, Sydney, June

¹⁰ IPART, 2013, *Review of regulated electricity retail prices 2013 to 2016*, Sydney, June

that may result in further credit rating downgrades (as revenue allowed will not be sufficient to cover efficient costs as well as debt servicing costs) which will further increase debt servicing costs and so on.

I trust that the views expressed above will assist IPART in the preparation of a draft report on the WACC methodology which outlines an approach for determining the WACC that appropriately deals with uncertainty and changing market conditions as they affect the water utilities in NSW and that delivers consistent pricing outcomes for their customers.

Yours sincerely

A large black rectangular box redacting the signature of Kim Wood.

KIM WOOD
Managing Director