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Mr James Cox PSM
Chief Executive Officer and Full Time Member
Independent Pricing and Regulatory Tribunal
PO Box Q290
QVB Post Office NSW 2130

Dear Mr Cox,

SCA comments on the Interim Report on WACC Methodology

The Sydney Catchment Authority (SCA) appreciates the opportunity to provide comments on the Independent Pricing and Regulatory Tribunal's (IPART's) Interim Report on Weighted Average Cost of Capital (WACC) Methodology.

The WACC is an important component in regulated utilities price determination. The development of a robust and reliable methodology is essential to ensure that utilities are not over or under compensated for its funding cost as both outcomes are not in the best interest of the end customers.

The SCA welcomes the Interim Report as a useful document that provides the details behind IPART's preferred 'short-short and long-long' approach which IPART presented at the workshop held in March. However, the SCA advises against adopting the approaches described in the Interim Report in the final methodology. As noted in its submission of 3 April 2013, the SCA considers IPART's preferred option as an improvement on the current approach and supported it as an interim measure until a more robust methodology is developed. However, the SCA continues to advocate the use of long run trailing averages in estimating market parameters as it is best able to address the issue of parameter distortion caused by short term financial market volatility and one that could withstand the test of time.

The SCA's comments on specific areas of the Interim Report are in the attached document. I trust the comments would assist IPART in the review of the WACC methodology.

Should IPART officers wish to discuss this matter further, please contact Ed Chan on (02) 4724 2487.

Yours sincerely,


Ross Young
Chief Executive

Sydney Catchment Authority

Comments on IPART's Interim Report on WACC Methodology

Overall comment of IPART's interim approach

As noted in the SCA's previous submission, IPART's interim decision is an improvement on the current approach. However, the SCA argues the interim approach does not adequately address the objective that IPART sets out to achieve in this review, namely to increase the methodology's robustness under changing market conditions.

Under IPART's interim approach, utilities that share similar characteristics and whose regulatory periods cover largely the same time would still receive very different WACC determinations as a result of volatility in the financial markets. In the past year, there were periods where financial markets and indicators fluctuated wildly on the changes in the world's macroeconomic outlook. The WACC determination for two similar utilities (and indeed for the same utility) could be significantly different within the space of a few months. In the SCA's view, this approach does not increase the methodology's robustness and creates outcomes that are neither predictable nor consistent.

Consistency in market-based parameter estimation

In addition to internal consistency between elements within the calculation of the WACC, the SCA also urges IPART to ensure a consistent approach is applied between utilities, especially in relation to the selection of term-to-maturity target when estimating market-based parameters.

The SCA notes that IPART has adopted two different approaches when deciding the term-to-maturity target in the most recent regulatory determinations. In the 2013 regulated electricity retail prices determination¹, IPART decided to adopt a 10-year term-to-maturity for market based parameters (a departure from its standard approach of 5-year term-to-maturity target), whereas for water utilities (Hunter Water Corporation², Gosford City Council and Wyong Shire Council³), it continued to use a 5-year term-to-maturity target. IPART states the use of 10-year target term to maturity for the electricity sector reflects the financing practices of competitive businesses with long asset life and where regulatory period is not relevant.

The SCA argues that the use of 5-year term-to-maturity target for the water utilities does not follow the broad principle of sound regulation, especially in relation to the principle of *'consistently applied over time and between utilities'*. Further, the SCA considers this approach is inconsistent with the IPART's stated regulatory objective in determining the WACC.

The use of a shorter term-to-maturity target for water utilities implies the expected lives of water utilities' assets are shorter than that of electricity generators. This is incongruous with the fact that water infrastructure assets generally have expected life of greater than 60 years⁴. The SCA argues that the financing practices for firms with long-lived assets are the

¹ IPART (2013), Final Report – Review of Regulated Retail Prices for Electricity from 1 July 2013 to 30 June 2016

² IPART (2013), Final Report – Hunter Water Corporation's water, sewerage, stormwater drainage and other services. Review of Prices from 1 July 2013 to 30 June 2017

³ IPART (2013), Final Report – Gosford City Council and Wyong Shire Council. Prices for water, sewerage and stormwater drainage services from 1 July 2013 to 30 June 2017.

⁴ In the SCA's 2012 determination, IPART set the asset life at 60 years for both new and existing assets. In Hunter Water Corporation's 2013 price determination, IPART set the asset life at 70 years for existing assets and 100 years for new assets.

same regardless of the industry that the utilities are in. IPART should therefore apply a consistent approach in setting the term-to-maturity target for both the electricity and water industry (i.e. 10-year target).

Selection of the WACC mid-point

As noted in previous submissions, the SCA believes the review of the WACC methodology should lead to a more robust approach that will deliver predictable and consistent outcome. The SCA argues that IPART's interim approach where the 'default WACC point estimate' is the mid-point of two mid points does not improve the methodology's robustness in volatile market conditions.

As the interim approach places equal weight on both short term and long term averages, it necessarily leads to a WACC outcome that would still be heavily influenced by short term market volatility and distortions. Under this approach, utilities that receive their price determinations during low market conditions are likely to be undercompensated for their funding cost. Conversely, utilities that receive their price determinations during a period of high market conditions are likely to be overcompensated for their funding cost. These outcomes distort the utilities investment decisions and are ultimately detrimental to the end customers.

Deviating from the mid-point WACC

As raised in the SCA's original submission, the SCA recognises the need for the regulator to exercise discretion in times of uncertainty. However, the SCA also argued that the exercising of discretion needs to be accompanied by transparent information and a clear framework to guide the decision making process. In this light, the SCA welcomes the articulation of a framework in determining the WACC in the interim report. However, if the interim approach is adopted, the framework needs to be further developed to include clear criteria, other than 'significance evidence' when IPART decides to deviate from the mid-point WACC. The SCA believes clearly articulated criteria would enable consistency and stability on the application of the framework.

Conclusion

The SCA believes the interim WACC methodology is an improvement on the current approach. However, it argues that it does not fully address the issue that the review sets out to achieve, namely to improve the robustness of the methodology under changing market conditions. The SCA urges IPART to consider adopting the long term trailing average approach as part of the WACC methodology and looks forward to providing further input in the review process.