Sydney WATER

SW Ref: CR 005340

Mr James Cox
Chief Executive Officer and Full-Time Member
Independent Pricing and Regulatory Tribunal of NSW
Level 8, 1 Market Street
SYDNEY NSW 2000

Dear Mr ~~Cox~~ Jim

Thank you for the opportunity to comment on the Independent Pricing and Regulatory Tribunal's (IPART) Discussion paper on estimating the debt margin for the weighted average cost of capital. Sydney Water supports IPART's objective of ensuring that its approach is transparent, robust and results in an unbiased estimate of the cost of debt.

IPART's paper raises a concern that a company's credit rating is no longer the prime determinant of the margin above the risk free rate it pays for debt. Instead, IPART suggests that since the onset of the financial crisis a company's industry sector is more important in determining its debt margin.

Sydney Water does not consider IPART's concerns to be warranted. The financial crisis represents a period of intense market disequilibrium. Behaviour of credit markets during this period is not a good guide to future credit market conditions. As such, it does not provide a sound basis for making long-term policy. There is already evidence that credit markets are returning to more normal conditions. For example the London Interbank Offer Rate, a generally accepted measure of banks' willingness to lend to each other, has retreated significantly from the very high rates at the peak of the crisis. (See attachment for details).

In the longer-term, stand-alone credit ratings provide an objective, independent assessment of the level of a company's risk, regardless of the sector in which the company operates. Sydney Water, therefore, does not support the option of moving to a portfolio of utility-specific bonds to determine the debt margin.

In addition, the utility-specific portfolio presented in the discussion paper has a higher average credit rating than that currently used as the benchmark for the debt margin. The utility-specific basket also has a higher average credit rating than IPART's analysis suggests water utilities will have by the end of their current determinations. As IPART notes 'Sydney Water's 'notional financial position (in particular the funds from operations over debt ratio) is relatively weak'. Adopting a utility-specific benchmark based on entities with better credit profile would underestimate the debt margin for Sydney Water.

Sydney Water supports a continuation of the current approach whereby the debt margin is set by reference to a relevant portfolio of bonds in the credit rating range BBB to BBB+ (the basket also includes Bloomberg's published 10 year BBB yield curve as one security in the basket).

The following attachment provides comments on IPART's specific questions. If you have any questions please call Sydney Water's Alan Ramsey on 8849 4819 or Stuart Wilson on 8849 5827.

Yours sincerely

Kerry Schott

Kerry Schott
Managing Director

18/6/09

Attachment: Response to the issues raised in the Discussion Paper

1. Should the benchmark for determining the debt margin be based on a target credit rating (ie. BBB+ or BBB) or on the issuer? (ie. Utilities)

Sydney Water supports a debt margin based on a target credit-rating, rather than the industry sector issuer.

The central thesis of the Discussion Paper appears to be that the industry sector a business operates in, rather than its individual credit rating, is a more important determinant of the debt margin. Evidence for this proposition is drawn from the experience of credit markets in the lead up to and during the financial crisis. Sydney Water does not consider that a period of intense market disequilibrium provides a sound platform for making decision about key parameters of the WACC.

There is some evidence that the impact of the Global Financial Crises on capital markets is easing. The available market data shows that inter bank lending has significantly improved since the peak of the Crisis. For example, the spread of three-month Libor[1], a gauge of banks' willingness to lend to each other, have now significantly recovered from their high peaks during the crisis (Table 1). During the credit crisis there was significant scepticism of the ratings given to companies, particularly financial institutions, using very complex products. However, when the market returns to normal, credit ratings will again be the main driver of the credit margin.

Table 1: 3-Month London Interbank Offered Rates LIBOR

	EUR	US$	AUS$
October 2008	5.28-4.82	4.15-3.02	7.92-6.5
March 2009	1.81-1.5	1.2-1.19	3.81-3.67

The utilities-specific portfolio presented in the discussion paper is not an appropriate benchmark for NSW water utilities. The credit rating for the portfolio of utilities bonds is higher than the appropriate target rate for setting the debt margin. The utilities-specific portfolio appears to have a credit rating of AAA or AA+, rather than the current BBB+ to BBB. The higher ratings are not consistent with NSW Treasury policy, which targets investment grade credit ratings for State Owned Corporations. Investment grade bonds usually carry ratings in the range of BBB+.

2. Does the BBB fair yield curve continue to be an appropriate benchmark for regulatory purposes given that other regulators use a higher credit rating?

Sydney Water considers that the current practice (ie. the use of BBB fair yield curve) is an appropriate method given that it meets the NSW Treasury requirements while providing a reasonable estimate of the investment grade debt margin. Sydney Water notes that other regulators use a benchmark only one rating higher (at BBB+). By contrast, IPART's proposed utility-specific portfolio of bonds appears to have an average credit rating several grades higher than this.

Sydney Water also notes that the Australian Energy Regulator has reaffirmed BBB+ as an appropriate benchmark, rejecting a move to a higher benchmark.

[1] London Interbank Offered Rates

The comments provided under point seven are relevant to this issue as well.

3. Should bond yields be adjusted to account for the maturity mismatch between the target of 10-years and actual term-to-maturity?

Sydney Water agrees that the maturity mismatch should be dealt with by an appropriate adjustment methodology. Assuming a normal yield curve, failure to adjust when the benchmark contains shorter-dated maturities will understate the debt margin.

4. If credit wrapped bonds are used, should an allowance for credit wrapping costs be included in the estimates of efficient operating expenditure?

Credit wrapping involves a higher rated issuer insuring the bonds of a lower rated issuer. The resulting credit rating relates to the insurer rather than issuing company. Including credit wrapped bonds in a benchmark, is contrary to IPART's criteria of using a benchmark with similar credit risk to the regulated corporation. Sydney Water therefore considers that credit wrapped bonds should be excluded from any portfolio used as a benchmark.

Were credit wrapped bonds to be used, Sydney Water considers that credit wrapping costs should be included in the operating expenditure, however, this is a secondary issue to whether they should be used at all.

5. Given the restrictions on access to CBASpectrum data, is Bloomberg the best available data provider?

In view of the access restriction to CBASpectrum, Sydney Water agrees with IPART's proposal to switch over to the Bloomberg.

The Discussion Paper states that on average, Bloomberg over-estimate the yields by about 6.7bp and CBASpectrum underestimate by 20.3bp[2]. However over the last two years, CBASpectrum was significantly higher than Bloomberg. Interestingly, the graph in Figure 5.8 shows that until mid 2007, when the clear signs of the Global Financial Crisis start to emerge, the two yield spreads were running very close to each other. The situation changed with the onset of the crisis where the two yield spreads followed the same pattern but with a widening gap between them. Overall, consistent with its view that the financial crisis represents a short-term market disequilibrium, Sydney Water considers the disparity between Bloomberg and CBASpectrum will reduce significantly over time and that utilities will not be disadvantaged if Bloomberg is used to set debt margins.

6. Should volatility in the corporate bond market be addressed by using a 20-day average of quotes (consistent with the current approach) or should a longer or shorter period be used?

The current approach is acceptable to Sydney Water. However, there may be a justification for IPART to use longer period to reduce the effects of market volatility. In principle, Sydney Water believes that as the pricing decisions made on the basis of the relevant data usually stand valid for 4-5 years into the future, IPART should use

[2] Discussion Paper May 2009, p12

sound, reliable data reflective of the normal market conditions for their pricing determinations.

7. Would a change in the target credit rating of the benchmark bonds portfolio impact on IPART financial ratios analysis and credit rating of the regulated business?

Changing the target credit rating of the benchmark bonds portfolio would have a significant impact on the financial ratios analysis undertaken by IPART *and* on prices set by IPART. There is a need to match credit rating (and the fair yield curve used to estimate the debt margin) with the financial analysis IPART undertakes to meet its obligations under the IPART Act. According to IPART's Determination Reports, recent Determinations result in BBB+ credit ratings by the end of the determination period for Sydney Water and Hunter Water. This is based on the projected FFO/interest and debt equity ratios. The use of target credit ratings to estimate the debt margin should be consistent with the above approach. This would not be achieved if a utility-specific benchmark bond portfolio with higher credit ratings were used.

If IPART adopts it utilities-specific benchmark, it should be prepared to provide sufficient cashflows in its determinations to allow utilities to achieve higher credit ratings. This would have a significant impact on prices.

8. How should the benchmark composition of the bonds be adjusted, and should bonds that may be perceived as mispriced on temporary or permanent basis be excluded?

Sydney Water is of the view that no change is required to the current benchmark composition of the bonds.

Sydney Water considers that the current benchmark bond portfolio delivers a satisfactory outcome for a commercial business entity, having regard to the possible market conditions encountered by new entrants to the water industry. It is not necessary to exclude some bond because they are being mispriced in the current market. The current market conditions are not normal and when conditions return to normal, the prices will follow suit.

9. Do you have comments on Erik Schloegl's proposed adjustment methodology set out in the accompanying advice to IPART?

Sydney Water is unable to comment on the above as further research and modelling would be required to form a view.