HW2007-2390/11

19 June 2009

Independent Pricing and Regulatory Tribunal
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By Email: 19 June 2009
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Dear Sir/Madam

Estimating the debt margin for the weighted average cost of capital

Hunter Water has reviewed the discussion paper issued by IPART in May. This discussion of the debt margin is timely in the light of the following observations resulting from IPART's current review of Hunter Water's prices.

Hunter Water's review of IPART's April 2009 draft price determination indicates that the Corporation will maintain an investment grade credit rating throughout the 2009/10 to 2012/13 price path period.

It should be noted that in order to achieve this investment grade rating, there is very little scope for unfavourable movements in key assumptions such as revenue streams, operating costs and the cost of debt. This is particularly the case for the financial years 2011/12 and 2012/13.

Of particular concern is Hunter Water's exposure to interest rate risk. Future spending on critical infrastructure will result in a significant increase in debt. This, in turn, will result in a substantial increase in interest costs over future price periods.

The impact of potential interest rate increases in the years beyond the next price path is even more profound. For example, assuming a 2.5 per cent increase in interest rates, the profit before tax for 2016/17 decreases by more than 60 per cent.

In Hunter Water's view, aspects of the current price determination methodology need to be reviewed for future price path determinations. While projected net revenue assumptions take into account such variables as demand changes and prudent operating expenditure levels, the current method does not take account of potential changes (increases) in the cost of debt.

This issue is of increasing importance to Hunter Water because the ratio of interest expense to operating costs is dramatically increasing when compared with previous years. For example, in Hunter Water's case, the relativity between interest expense and operating costs will rise from around 40 per cent (of operating cost value) in 2009/10 to 106 per cent in 2015/16.

There is a strong argument that the weighted average cost of capital (WACC) should reflect, as a minimum, the likely market conditions over the term of the price path rather than be set on the market conditions at the month of finalising the price determination. Under the current methodology, the WACC has no direct correlation with Hunter Water's actual cost of debt. Instead the WACC calculation applies market-determined risk-free rates based on a 20-day average yield at a time just prior to the start of the relevant price path. The relevance of adopting this single point estimate of WACC to a four year price path is questionable.

This approach ignores the fact that there may be considerable changes in the risk-free rate and hence to the cost of debt acquired over the four-year price period. The current global financial crisis is a prime example of the volatility of the debt and equity markets.

Further disparity between the IPART determined WACC and true cost of Hunter Water's debt can result from pre-existing fixed debt. The WACC is determined with no reference to the cost of fixed debt already locked in place by Hunter Water. These debt parcels may have been acquired up to ten years prior to the price determination in question. For this reason, the risk-free rate incorporated in pre-existing debt parcels is unlikely to resemble the risk-free rate used for determining WACC at the time of the price determination.

The outcome of failure to consider both forward interest volatility and the true cost of currently-held debt is likely to be a 'mismatch' between revenue streams designed to cover the cost base versus the true costs being incurred by Hunter Water. Hunter Water looks forward to this issue being addressed for future price determinations.

Thank you for the opportunity to comment. Please do not hesitate to contact me on 02 49799748 or Sharon Smith, General Manager Business Services, on 02 49799411 if you require further information.

Yours faithfully

JOHN O'HEARN
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Business Strategy
and Communications