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Independent Pricing and Regulatory Tribunal
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By Email: 12 August 2011
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Dear Sir/Madam

The incorporation of company tax in price determinations

Thank you for the opportunity to respond to IPART's recent discussion paper on the possibility of incorporating company tax in price determinations. The calculation of the weighted average cost of capital (WACC) is a relatively contentious issue and the source of numerous reviews and reports by regulators in Australia and overseas. As IPART is aware, Hunter Water does not have the in-house expertise or resources to engage in these reviews with the same rigour as regulators like IPART, the Australian Energy Regulator (AER) or major electricity utilities. Accordingly, Hunter Water's response reflects some initial high-level observations, after considering:

- the discussion paper only represents a summary of possible considerations at this stage, without a recommendation of any proposed change or its possible impacts,
- some of the specific issues raised represent complex technical issues and a comprehensive review using appropriate expertise and knowledge was not able to be resourced at present, and
- it would be desirable to consider this proposal together with earlier IPART proposals for changes to selected WACC parameters.

Given the complex nature of the subject, it may have been valuable to have had some preliminary discussion regarding the details and context of issues being raised. It would also be preferable for IPART to present and explain any proposed recommendations to agencies and then provide agencies with an opportunity to comment again on the proposed decision prior to any changes being adopted.

Hunter Water is aware that this review is a continuation of IPART's process of reviewing the WACC parameters, which started some years ago. However, Hunter Water believes that, given the range of parameters considered in the price setting process generally, it is difficult to assess the appropriateness of changing one specific WACC component (that is, the income tax rate) in isolation.

Calculation of the WACC for use in price determinations incorporates a degree of judgement. As we understand it, the determination of an appropriate WACC is derived from calculation of the midpoint from a range of WACC estimates based on range estimates for a number of key input

parameters to the calculation. This midpoint is then only used as a 'guide' for deciding the return a utility will be awarded (referred to as the "point estimate" in the determination reports), - that is, the point estimate is a judgement "... to achieve consistency with other recent determinations and to strike a balance between the interests of Hunter Water and its customers".¹ In Hunter Water's 2009 determination, the midpoint for the draft determination was 7.2 per cent while the determined point estimate WACC was 7.0 per cent. For the final determination, the midpoint was 6.8 per cent while the determined point estimate WACC was 6.5 per cent – 30 basis points lower than the midpoint.² In this context, and looking very generally at the effective rate of taxation for utilities in Table 3.2 of the discussion paper, it is conceivable that the effect of chasing further precision in the tax rate parameter may be lost deciding the final point estimate for the WACC.

Also, the values for the WACC adopted in pricing determinations appear to differ considerably across industries and utilities. In particular, the 'determined' WACC is applied to a value for the Regulatory Asset Base (RAB), which was initially set by the "line in the sand" methodology over a decade ago and not related directly to prior capital investment.

When it comes to consideration of tax, there is a range of inconsistencies that exist between the transactions and taxation of government utilities versus other corporate entities and the determination of profit for purposes of calculating 'Income Tax Equivalents' versus the measure of 'regulated' profit considered by IPART for pricing purposes. As such, the existence of a 'derived' RAB and its implications for calculation of depreciation, the existence of 'non-regulated' activities such as sales of recycled water and unique transactions such as capital contributions (and their subsequent depreciation) etc, mean that there will always need to be generalisations in the way these values are utilised for the different purposes.

In the context of the above points, the materiality of the change needs to be considered. Hunter Water estimates that changing the company tax parameter from the statutory 30 per cent to, for example, the effective rate of 28.1 per cent for utilities shown in Table 3.2 of the discussion paper would change the real pre-tax WACC range calculated in Hunter Water's 2009 price determination of 6.0 per cent to 7.8 per cent to a range of 5.9 per cent to 7.7 per cent with the mid-point remaining unchanged at 6.8 per cent. As discussed earlier, regulatory judgement in establishing the point estimate is likely to override the significance of a difference of this order. Even changing to an effective tax rate of 22 per cent as suggested by the AER³ only reduces the range to 5.8 per cent to 7.4 per cent with a midpoint of 6.6 per cent – 20 basis points less than the determination midpoint, and still above the final determination point estimate.

Further, as outlined in our 2009 submission on the debt margin, there is a strong argument that the 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 or the economic outlook for the price path. 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 therefore questionable.

This point is well illustrated by comparing the nominal risk free rate for the 20 days to 11 May 2009 of 4.6 per cent used in the WACC calculation for Hunter Water's prices with that applying for the 20 days to 10 December 2010 (18 months into Hunter Water's price path) of 5.4 per cent and used in

¹ IPART, 2009, *Review of prices for water, sewerage, stormwater and other services for Hunter Water Corporation*, Water – Final Report, July, Appendix G (G.1)

² IPART, 2009, Table G2

³ IPART, 2011, *The incorporation of company tax in price determinations. Other industries – Discussion Paper*, June, page 25.

the final determination of prices for the Water Administration Ministerial Corporation (WAMC).⁴ Interestingly too, although bulk water charges are a relatively minor contributor to Hunter Water's operating costs, the rate of return for the WAMC does flow through into Hunter Water's operating cost through the higher prices for the WAMC and without any recovery from Hunter Water's prices. Similarly, higher WACC-based rates of return for electricity utilities have a more significant, and unrecoverable, impact on Hunter Water's costs.

It is also questionable whether adjusting one arbitrary parameter – the statutory tax rate – is appropriate while adhering to other arbitrary parameters like the benchmark gearing ratio. It is interesting to note from Table 4.2 in the discussion paper that Ofwat and Ofgen move from benchmark gearing to actual gearing when gearing exceeds a threshold level. While Hunter Water's debt levels are below the benchmark ratio, with increasing debt levels, longer-term consideration may need to be given moving to actual gearing ratios in calculating the WACC.

Consequently Hunter Water would be very hesitant to endorse any proposal to change any single element in isolation. This is particularly the case where changing that element in itself would necessitate a degree of estimation (for example, replacing the statutory tax rate with an estimated effective tax rate for the utility sector), and particularly where it adds additional complexity to information already reported.

Hunter Water does not propose that the overall WACC methodology be completely reviewed and amended. However, we are not sure about the value of selecting only one element in isolation for possible change given the overall methodology applied. Rather Hunter Water believes it would be preferable to see a number of WACC issues considered together, including the issues we raised in 2009 in relation to the debt margin. Only by considering the proposals together can an appreciation be gained of the combined impact of amending IPART's approach to the WACC calculation.

We would be pleased to discuss this further with IPART.

Yours faithfully

SHARON SMITH
General Manager
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⁴ IPART, 2011, Review of prices for Water Administration Ministerial Corporation. For NSW Office of Water – from 1 July 2011, Water- Final Report, February, Table M.1