State water
Taking care of it

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Mr James Cox
Chief Executive Officer
Independent Pricing and Regulatory Tribunal
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Dear Mr Cox

Submission on the incorporation of company tax in price determinations

State Water welcomes the opportunity to respond to the Independent Pricing and Regulatory Tribunal (IPART's) discussion paper - incorporation of company tax in price determinations.

State Water's issues of concern are detailed in the attached submission.

If you wish to discuss the State Water submission further please contact Joseph Caruana, Regulatory Analyst, on 02 8245 2074, or joseph.caruana@statewater.com.au

Yours sincerely

Lisa Welsh
General Manager
Strategy and Government Relations

Pre-tax WACC vs. Post-tax WACC

State Water's preference is to retain the real pre-tax Weighted Average Cost of Capital (WACC) formulation currently adopted by IPART. The use of a post tax rate (or more importantly the use of an actual expected tax liability instead of a statutory tax rate) effectively translates to a zero tax rate for State Water due a tax office ruling which allows accelerated depreciation of most of State Water's capital expenditure. The accelerated depreciation will result in accumulated tax losses beyond the next determination period.

The tax incentive promotes efficient investment in rural water infrastructure with flow on economic benefits to these areas. A move to a post-tax WACC calculation reduces the incentive for a business such as State Water to minimise its tax liabilities, as the tax revenue saved from undertaking tax minimisation strategies will automatically be transferred to customers via a reduction in State Water's operating revenue requirement. State Water's ability to use accelerated deprecation was designed as a tax incentive to increase rural water investment and not reduce regulated revenue requirements.

State Water corporatisation and past IPART decisions

IPART would be aware that the continued use of a pre-tax WACC by IPART has resulted in current Regulated Asset Base (RAB) values for State Water that would have been different had a post-tax WACC been used. Following State Water's corporatisation, IPART considered the various arguments for, and implications of, adopting either the annuity or RAB approach for State Water in its 2006 Determination:

> *"The Tribunal has used a RAB approach in other industries, and considers that this approach is generally superior in terms of economic efficiency and regulatory effectiveness. For this reason, it considers that in the long term, a decision to adopt the RAB approach for bulk water pricing is inevitable."*[1]

IPART acknowledged that in changing from the annuity approach to the RAB approach, it was necessary to reconsider the opening value attributed to the RAB. IPART also acknowledged that if a RAB approach had been adopted in previous determinations, a higher opening RAB (rather than zero) would have been adopted to result in the same level of prices as under the annuity approach.

In determining an opening RAB valuation for State Water, IPART indicated support for the approach taken by the Government, however adjusted the capitalisation

[1] IPART, Bulk Water Prices for State Water Corporation and Water Administration Ministerial Corporation, September 2006, page 27

rate (using a pre-tax WACC of 7.0% and depreciation rate of 0.6%) to derive an opening 1 July 2004 RAB valuation of $241 million for State Water (and a valuation of $46.5 million for the Fish River Water Supply Scheme). State Water adopted the above WACC value based on the understanding that a pre-tax WACC would continue to be used. State Water would have recommended a lower WACC value to calculate the opening RAB had it be known the regulator would move to a post-tax WACC calculation.

IPART's 2002 discussion paper on the WACC argues the advantages of a pre-tax WACC compared to a post-tax WACC are its light handed nature and its appropriateness for Government owned utilities. The discussion paper also identifies the disadvantage of the post tax WACC is the risk of under or over estimating tax liabilities. It is not clear from the current issues paper whether IPART has changed its position after almost 10 years the release of the 2002 discussion paper.

Adverse impact on State Water

The current discussion paper suggests that water businesses will experience an estimated 4 per cent reduction in revenue should the tax rate be reduced to 22 per cent (this assumes roughly 40 per cent of revenue is derived from the return on capital). However, State Water estimates a movement to a post tax WACC will reduce State Water's equivalent pre-tax WACC by approximately 90 basis points.[2] Therefore the impact on State Water's revenues will be far greater than 4 per cent.

This reduction in revenues is likely to adversely affect the financeability of our prudent, efficient business. Despite this, the discussion paper does not explore options for compensation and transitional arrangements to mitigate the impact of such a significant drop in revenue previously considered efficient by IPART, should the regulator choose to use a post-tax weighted average cost of capital in future pricing determinations.

State Water believes that IPART should undertake a detailed analysis of the impact on businesses before releasing the final report. Furthermore, as IPART has already determined existing regulated revenues to be prudent and efficient, any move to a post-tax WACC regime should be revenue neutral to regulated businesses.

Statutory and effective tax rate

State Water is of the view that a statutory tax rate (currently 30%) more closely aligns to IPART's objective of determining a cost base for an industry and is not business specific.[3] The statutory tax rate is determined independently as a matter

[2] Based on WACC parameters adopted in IPART's 2010 Review of Prices to be charged by State Water Corporation, including 30 per cent statutory tax rate.

[3] IPART 2011, *The incorporation of company tax in price determinations*, p.5

of Commonwealth Government policy and applied uniformly across the Australian economy. It is true that individual businesses receive rebates and tax incentives, however in most cases these are business specific and the attempt to net them out and calculate a businesses' actual tax liability would contradict IPART's objective mentioned above.

Further, the use of sectoral effective tax rate benchmarks is a highly inaccurate way to calculate actual tax liabilities. Firstly, the industry categories presented in the discussion paper are highly subjective. State Water falls under the category electricity, gas, water and waste water services. State Water has significantly different asset characteristics to electricity distribution, network business and waste water services who use purpose built infrastructure to deliver their products. State Water on the other hand uses natural river systems to make the water available. This inturn impacts on the entities tax liabilities. Even within the water sector, State Water's asset characteristics differ to Sydney Water due to the different customer characteristics and geographical location. In addition, the calculation of a broad average across the subjective group does not take into account the possible variation in actual tax liabilities.

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