Sydney WATER

11 October 2011

Mr Jim Cox
Chief Executive Officer
Independent Pricing and Regulatory Tribunal
Level 8, 1 Market Street
Sydney NSW 2000

Dear Mr Cox

I refer to the draft research report on the incorporation of company tax in pricing determinations, released by the Tribunal recently. The Tribunal has invited submissions on the matters addressed in that report.

This submission is being made on behalf of SDP Pty Ltd (SDP). Staff and advisors to the SDP Project team have read and understood the proposals set out in the Report. In general, our analysis indicates that the framework and formulae set out in the Report replicate the approach adopted by the Australian Energy Regulator, amongst others. As such, for consistent debt to equity assumptions and depreciation methods and lives, it should provide a relatively fair transition from a pre to a post tax framework.

SDP would submit however that the clarity of the report could be significantly improved by the use of more precision in specifying terms in the various formulae, in particular by distinguishing between pre and post tax and real or nominal terms, and providing an explanation of the calculation basis of tax vs. regulatory depreciation (i.e. non-inflating vs. inflating asset base).

In practical terms, affected regulated entities and potential SDP capital providers will be particularly interested in IPART's intentions in relation to setting the debt to equity ratio for the purposes of calculating the interest effect in the tax building block. I assume that IPART intend to use the same debt to equity ratio assumptions for both tax and regulatory calculations but it would be helpful if the final paper provided clarification on this matter.

Similarly, clarity around how IPART intend to determine tax depreciation will be most important. While it is assumed that the tax calculation will use the tax base and depreciation lives allowed by the taxation Commissioner as distinct from the regulatory lives of the same assets, if the intention is to reflect the tax regime facing regulated entities, then there should be no assumed change in depreciation method that is not actually available to the entity concerned. In the case of SDP for example, we have adopted a straight-line depreciation method for tax purposes and there is no provision under the tax Act for this to be changed to a diminishing value method. In these circumstances it should not be open to IPART to use a different depreciation method for the tax building block calculation.

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All of these matters would be most appropriately addressed by IPART publishing a model together with a worked example of the proposed framework so that interested parties can see how the proposed framework is intended to be applied in practice. I understand that this has been the approach followed by other Australian Regulators and we strongly recommend it to IPART.

Finally, I need to address the material covered under Paragraph 5.2 of the draft Report relating to SDP. In this section IPART utilises the recent SDP pricing submission as an illustrative example of the application of the move to a post tax framework.

The use of these figures significantly distorts the impact of the pre to post tax transition. This is because the SDP price submission was never compiled in the context of a post tax framework.

The temporary and unsustainable debt to equity ratio reflected in the submission arose as a result of the assumed purchase of the Kurnell to Erskinville distribution pipeline by SDP, which was assumed to be totally financed by additional borrowings. This assumption created a very high leverage position in SDP with consequent large apparent interest costs. However this was intended to be a very short-term outcome pending the re-payment of the TCORP debt load as a result of the re-finance and the setting of a more commercial debt to equity ratio. Importantly it has no relevance in a pre-tax regulatory framework, which is what the SDP price submission was intended to address.

If these numbers are used to model a transition to a new post-tax regulatory world (ignoring the ATO thin capitalisation rules and the inability to obtain this level of leverage through debt capital markets or through bank finance), then it will generate apparently very large tax deductibles for interest and potentially an effective tax rate of zero. This is the situation reflected in Table 5.5 of the draft Report and the associated commentary. This outcome is an artefact of the purely temporary debt load assumed in SDP prior to the re-financing and its use in the draft report creates a misleading impression of the application of the pre- to post tax transition to SDP.

Thank you for the opportunity to comment on this important proposal. Should you or your staff wish to discuss this further please contact either myself on 02 8849 4819 or Alan Ramsey on 02 9216 7435.

Yours sincerely

Kerry Schott
SDP Project

11.10.11