



11 August 2011

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

**Re: The incorporation of company tax in price determinations**

Dear Mr Cox

Sydney Water welcomes the opportunity to comment on IPART's discussion paper on the incorporation of company tax in price determinations.

In principle Sydney Water has no objection to moving to a post-tax framework. Such a move would potentially more accurately reflect Sydney Water's true financial performance and revenue requirements.

However, the treatment of tax in the regulatory framework is important, wide reaching and potentially complex. Sydney Water considers that an inter-agency work group is required to consider issues as significant as moving from a pre-tax to a post-tax modelling framework. Further, in line with best practice, if IPART moves to a post-tax framework it would be beneficial for all parties if IPART published its post-tax model on its website.

In this context Sydney Water offers the following preliminary comments on the issues raised in the discussion paper. At the highest level, the discussion paper sought comment on whether IPART should:

- continue modelling in a pre-tax framework, taking account of tax liabilities via the weighted average cost of capital, or
- move to modelling on a post-tax basis, which would require a separate building block component which explicitly addresses taxation.

As IPART identified in the discussion paper, the increasing movement toward employing a post-tax framework both domestically and internationally supports modelling in a post-tax framework.

Various academic papers have sought to address the issue of the limitations of using a pre-tax WACC as opposed to a post-tax WACC. The main issues in support of a post-tax framework can be briefly summarised as follows:

- Using actual tax payments in a post-tax framework is more accurate and transparent than using the corporate tax rate or estimating an effective tax rate in calculating the WACC in a pre-tax framework.
- Using a nominal post-tax approach overcomes the problem of having to convert a post-tax nominal rate of return to a pre-tax real rate of return. Methods commonly used to convert a nominal post-tax WACC into a real pre-tax WACC are not entirely correct because they fail to accurately capture the effect of tax depreciation.
- The use of a nominal post-tax rate of return is simpler to understand than a real pre-tax rate of return.

IPART has presented alternatives for modelling in a post-tax framework in its discussion paper. The alternatives vary considerably in their complexity and their representation of a regulated entity's actual tax position. Sydney Water is of the view it is only worth moving to a post-tax framework if it is representative of Sydney Water's actual tax position, has minimal additional information requirements and complexities are mitigated.

An approach that may address these issues is to use the tax payable estimate from a regulated entity's Statement of Corporate Intent (SCI) as the tax allowance to be included in the estimation of an entities annual revenue requirement. Using this approach will be significantly more representative of a business actual tax position than a pre-tax framework, or a post-tax framework which uses regulatory depreciation and regulatory interest expensive to derive the base on which tax is to be calculated.

A shortfall of this approach is that the tax payable in an entity's SCI is calculated taking into account both regulated and unregulated revenue. A simple approach to overcome this is to allocate the tax payable between regulated and unregulated services on a proportional basis to revenue. This approach assumes that both regulated and unregulated services attract the same rate of return.

Sydney Water suggests that these propositions be tested through an interagency working group comprising IPART, and utilities affected by the change. If you have any queries in relation to these preliminary comments, please contact Greg McLennan on 8849 5703.

Yours sincerely 

  
Alan Ramsey  
**General Manager**  
**Finance and Regulatory**