

9 April 2009

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

Dear Mr Cox

Adjusting for expected inflation in deriving the cost of capital

Thank you for the opportunity to comment on the Independent Pricing and Regulatory Tribunal's (IPART) Discussion Paper, *Adjusting for expected inflation in deriving the cost of capital*.

Summary

The discussion paper canvasses the biases in the current method of adjusting the nominal weighted average cost of capital (WACC) for inflation to derive the real WACC. It examines two alternatives. One is based on new financial market data, and the other is based on economists' forecasts, as currently used by the Australian Energy Regulator (AER) and the Essential Services Commission (Victoria).

Sydney Water considers that IPART should use all relevant data to make an informed decision on expected inflation.

Sydney Water is not well placed to assess whether inflation-indexed swaps will over time provide a superior estimate of inflation. However, the current observed volatility in financial markets is unprecedented. Governments are also actively intervening in financial markets, and the form and extent of this intervention is still unfolding. Given this, there is no guarantee that IPART's proposed new market-based approach for calculating the real risk-free rate and expected inflation will not suffer from underlying problems as observed with its current method.

Having regard to economists' forecasts of inflation would promote consistency in utility regulation and minimise regulatory costs because the approach is widely used by regulators such as the AER. IPART's approach to adjusting for inflation needs to be considered in the overall context of how other WACC parameters are set. IPART does not adopt a mechanistic approach to setting the WACC. Recent decisions demonstrate that it has discretion over the setting of the final WACC regardless of the outcome for market-based parameters.

Background

In calculating the WACC of a regulated utility, IPART currently uses observed market data in determining interest rates, inflation and the debt margin. As shown in table 1, recent volatility in

financial markets has increased the mid point estimates of the WACC from around 6.5 per cent to over 8 per cent. A modest decrease in the real risk-free rate is being more than offset by increases in the debt margin. The decisions in table 1 are directly comparable with each other because IPART has used the same value for all other WACC parameters.

Table 1 Market-based WACC parameters

Parameter	Sydney Water (previous)	Sydney Water (current)	CityRail (final)	Gosford/Wyong (draft)
Nominal risk-free rate	5.2%	6.1%	5.2%	4.2%
Real risk-free rate (a)	2.8%	2.6%	2.5%	2.8%
Inflation	2.5%	3.6%	2.7%	1.3%
Debt margin	1.13%-1.22%	3.1%-3.7%	2.9%-6.0%	1.2%-3.6%
WACC range (real pre-tax)	5.4%-6.9%	6.8%-8.4%	6.5%-9.7%	5.9%-8.8%
WACC mid point (real pre-tax)	6.5%	7.5%	8.1%	7.2%
IPART determined WACC	6.5%	7.5%	7.2%	7.0%

Notes: (a) IPART has included a 20 basis point 'scarcity' premium to the real risk-free rate for Sydney Water's current WACC and the CityRail and Gosford/Wyong decisions.

Sources: IPART Determinations for Sydney Water (June 2005 and June 2008) CityRail (Dec 2008) and Gosford/Wyong (March 2009).

As a consequence of market volatility, IPART has been exploring ways of adjusting the market data used in the WACC. Given the wide margins on some parameters this has involved an element of judgement. For example, one adjustment applied to Sydney Water's current WACC was to add 20 basis points to the observed real risk-free rate. However, IPART also appeared to change the maturity date of the bonds used to calculate the real risk-free rate from 2015 to 2020 between the draft and final determination. This actually reduced the WACC from 8.5 per cent (based on the maturity date used in the draft determination) to the final approved 7.5 per cent.

For the CityRail and Gosford/Wyong decisions, IPART has set the WACC below the mid point estimate. In the case of CityRail, IPART set the WACC almost one per cent below the mid point because it was concerned that current market conditions in the Australian debt market may not reflect the actual cost of debt a commercial public rail transport operator would face in a competitive market.¹ In the case of Gosford/Wyong, IPART reduced the WACC below the mid point to balance concerns over the average bills paid by customers with financial viability.²

IPART's proposed new market-based method

IPART's new proposed market-based method is in response to concerns over the observed outcomes under the current method. However, additional issues may arise in the short to medium

¹ IPART (Dec 2008), *Review of CityRail Fares*, 2009-20012, p. 78.

² IPART (March 2009), *Gosford City Council and Wyong Shire Council, Prices for water, sewerage and stormwater drainage services from 1 July 2009 to 30 June 2013*, p. 61.

term that could cause problems for the new proposed method. Given the current problems with global financial markets, governments are actively intervening in financial markets, and the form and extent of this intervention is still unfolding. This intervention may generate more observed biases in observed market outcomes. Given this, there is no guarantee that IPART's proposed new market-based approach for calculating the real risk-free rate and expected inflation will not suffer from underlying problems as observed with its current method.

Sydney Water would also note that the attached paper by Erik Schlögl is technical and beyond the ability of all but appropriately trained individuals to provide meaningful comment. The AER's approach is readily understood and based on data freely available to any interested party.

At a minimum, the outcome of inflation-indexed swaps should be sense-checked against economists' forecasts of inflation.

The Australian Energy Regulator

While Sydney Water does not suggest that IPART rely exclusively on the AER approach, having regard to economists' forecasts of inflation will promote regulatory consistency, lower regulatory costs and potentially improve the transparency of decision-making.

Regulatory consistency is desirable and is promoted through having more monopoly infrastructure in Australia regulated in a similar way. Regulatory costs are reduced because the approach to dealing with generic issues can be analysed and decided upon in one review.

Currently, the AER estimates inflation over a 10-year period by applying the Reserve Bank of Australia's short-term inflation forecasts - currently extending out to two years - and adopting the mid point of its target inflation band beyond that period (ie 2.5 per cent) for the remaining eight years. An implied 10-year forecast is derived by averaging these individual forecasts.³

The Reserve Bank is more than an economic forecaster. Should financial markets consistently estimate future inflation outside the Reserve Bank's target range, it could be expected that the Reserve Bank would take action to ensure that its target outcomes are met.

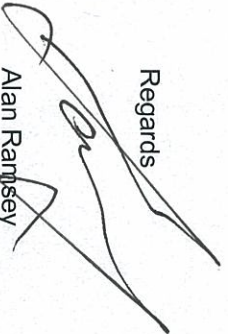
³ Australian Energy Regulator (2008), *New South Wales, Draft Distribution Determination, 2009-10 to 2013-14*, p. 227.

Conclusion

IPART exercises considerable regulatory discretion in setting the final WACC, regardless of the outcomes for any individual parameter. This discretion is used in response to both concerns over individual parameter outcomes (for example, CityRail's debt margin) or the overall impact of the WACC on the final prices paid by consumers. Consistent with this approach Sydney Water suggests that IPART use all relevant data in adjusting for inflation in the WACC.

If you require any further information, please contact Stuart Wilson, Manager, Regulatory Strategy and Pricing.

Regards



Alan Ramsey
General Manager, Finance and Regulatory