

1 December 2017

Dr Peter Boxall
Chair
Independent Pricing and Regulatory Tribunal
PO Box K35
Haymarket Post Shop, NSW 1240



Dear Dr Boxall,

Submission to IPART's review of its WACC method draft report

The Public Interest Advocacy Centre (PIAC) is an independent, non-profit legal centre based in New South Wales. Established in 1982, PIAC tackles systemic issues that have a significant impact upon disadvantaged and marginalised people. We ensure basic rights are enjoyed across the community through litigation, public policy development, communication and training. The Energy + Water Consumers' Advocacy Program represents the interests of low-income and other residential consumers, developing policy and advocating in energy and water markets.

PIAC welcomes the opportunity to respond to the Issues Paper for the Independent Pricing and Regulatory Tribunal's (IPART) review of its Weighted Average Cost of Capital (WACC) methodology. PIAC limits its comments on the WACC methodology to its application to water services.

PIAC supports IPART's routine review of its WACC methodology to ensure that it remains fit for purpose. PIAC considers that the stability and consistency of the WACC are generally positive outcomes for consumers yet stresses the importance of keeping WACC no higher than necessary, particularly to support affordability and allow households to effectively budget for the essential service of water.

Consumer impacts must remain central to the discussion

Consumer impacts are central to any regulatory decisions. They must remain front of mind in any discussions regarding the process and method for regulatory determinations. While WACC, and hence the method of calculating it, plays a significant role in the bills that consumers pay, it can be an arcane and inaccessible subject. It can therefore be difficult to gather informed consumer input on preferences.

PIAC accordingly welcomes IPART's inclusion of a new principle for its review that:

[IPART's] WACC method should produce reasonably accurate estimates of the cost of capital. This will ensure that customers do not pay more than necessary and that the regulated firms will be financially viable and have the incentive to invest in the efficient level of productive assets.¹

Keeping this principle central to the review should help minimise risk that stakeholders lose sight of the overarching role of WACC in regulatory price and revenue determinations and instead become caught up in an academic or technical debate over which method or model is inherently 'better.' The more important consideration is the defensibility of the assumptions used in developing inputs into the model.

¹ IPART, *Review of our WACC method Draft Report*, 2017, p. 11.

Cost of debt

PIAC supports IPART's position in not immediately employing a trailing average cost of debt. This would inappropriately reflect the high cost of debt values from the global financial crisis, which would not be in the interests of consumers.

PIAC notes that IPART's proposed true-up method would have generally resulted in a small adjustment to the following period's prices and generally averaged to zero over successive years.² However, this is dependent on the quantum and trend of the input parameters during this period. It is not clear how representative this historical data is of future trends.

Therefore, PIAC would welcome further discussion from IPART regarding how representative the historical data would be of future trends in the input parameters and hence outcomes for consumers.

Passing through cost of debt true-ups to consumers

True-ups may average out to zero over several years or may form a more sustained trend. In addition to cost of debt true-up, there may be other pass-through events and true-ups between successive years and/or regulatory periods. It is possible that these may cancel out, or they may compound and so exacerbate the impact on final consumer prices. It is important to consider the cumulative impact of these on the prices and bills faced by consumers.

PIAC understands that it may be possible to pass through cost of debt true-ups to consumers either at the start of each year or at the start of the next regulatory period. All else being equal, PIAC considers that consumers are best served through predictability in their bills.

Therefore, PIAC recommends IPART develop a mechanism of passing through costs to consumers which minimises their exposure to short-term fluctuations but also provides some smoothing of any step-changes or trends.

Synchronising data sampling

IPART has proposed amending its methodology to synchronise sampling dates and periods for selected current parameters and acknowledge the potential correlation between many of these parameters. PIAC supports the intent of this amendment.

The Benchmark Efficient Entity

PIAC supports IPART's approach of using a Benchmark Efficient Entity (BEE) in its WACC determinations. PIAC also generally supports the use of observed behaviour of current regulated firms as a guide to developing the efficiency benchmark to ensure that the defined BEE is reflective of current business practices.

However, the central concern in developing a BEE is to ensure that the risk and cost profiles of the BEE reflect those of an efficient regulated business. PIAC acknowledges the difficulties in finding appropriate proxy companies to do so. Because of this, caution should be exercised when broadening the range of businesses in the set of proxies such as including businesses operating in competitive markets.

² IPART, *Review of our WACC method Draft Report*, 2017, p. 25.

Simply adding more entities to the sample may make the data more statistically reliable but may also make the comparison less valid. PIAC recommends that IPART be mindful of this in its proposal to use the broadest possible selection of proxy companies.

Calculating inflation

PIAC supports IPART's reasoning regarding its method for calculating inflation using a geometric average. PIAC is inclined to support methods which are accessible and can be scrutinised by all stakeholders over methods which may be more theoretically 'pure' but lack transparency and replicability.

Continued engagement

PIAC would welcome the opportunity to meet with IPART and other stakeholders to discuss these issues in more depth.

Yours sincerely,

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