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WATER
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Dear Dr Duc Vo

Rate of Return Guidelines Review

The Water Corporation welcomes the opportunity to comment on the draft rate of return guidelines published by the Economic Regulation Authority (ERA) on 6 August 2013.

We note that the requirement for the rate of return guidelines has resulted from the review of the national gas and electricity rules relating to the calculation of rate of return. The review followed shortly after recent determinations by the Australian Competition Tribunal (ACT). The determinations were based on the ACT's interpretation of the previous version of the rate of return rules.

The new rule sets out a new approach. It requires an examination of the evidence from relevant financial models, estimation methods, together with evidence from financial markets. This evidence is then weighted to arrive at a rate of return which meets an explicit "allowed rate of return objective" as required under National Gas Rule 87(2). The change in the wording of the new rate of return rules for gas and electricity reflect the concern of the Australian Energy Market Commission (AEMC) that the current approaches being applied by regulators and reinforced by the ACT was formulaic and lacked the flexibility required to deal with changing market conditions and new evidence.[1]

The approach adopted in the draft guidelines continues to be largely formulaic and would appear not to address the AEMC's desire to achieve the allowed rate of return objective set out in National Gas Rule 87(3) being that "the rate of return for a service provider is to be commensurate with the efficient financing costs of a benchmark efficient entity with a similar degree of risk as that which applies to the service provider in respect of the provision of reference services". This is of concern to the Water Corporation to the extent that the guidelines would be applied in determining our rate of return as well.

The cost of equity is still to be based on the Sharpe-Lintner Capital Asset Pricing Model (CAPM). While the Sharpe-Lintner CAPM has been insightful into the relationship between risk and returns of investments there has since been much further work undertaken in this area. The Sharpe-Lintner CAPM has well known

[1] Australian Energy Market Commission, *Rule Determination, National Electricity Amendment (Economic Regulation of Network Service Providers) Rule 2012, National Gas Amendment (Price and Revenue Regulation of Gas Services) Rule 2012,* 29 November 2012, page 44.

shortcomings because it is a simplistic representation of reality. It would be useful for the guidelines to address these shortcomings and we suggest that an approach similar to that detailed by the Australian Energy Regulator (AER) in its draft guidelines issued in August 2013 be considered. The AER proposes to take into consideration the outputs of a number of models plus relevant market data and evidence in determining an appropriate return on equity. The types of models and evidence which could be considered include Black's CAPM, dividend growth models, current equity returns for comparable entities and the views of investment bankers and other advisors.

The cost of debt is still to be based on a risk premium calculated through the use of the ERA's bond yield approach plus the risk free rate. The risk free rate based on 5 year Commonwealth Government bonds is to be reset annually within a 5 year access arrangement period. The observations made by the Western Australian Treasury Corporation (WATC) on the practical implementation of the approach to cost of debt on swap prices and the alternative methods for determining debt risk premium are worthy of greater consideration. WATC is our provider of debt and is an active and successful participant in capital markets. We share the concern that financial counterparties may be able to exploit the refinancing strategy implicit in the approach to cost of debt resulting in higher costs which will flow through to end use consumers. Furthermore, we believe the negative implications arising from the reporting of annual repricing exposure of debt in financial statements may have been underestimated. The cost of debt approach encourages regulated utilities into the area of financial engineering which does not reflect their core business and has the potential to introduce additional financial risk. The additional risk will be taken into account by lenders and ratings agencies and reflected in cost of debt.

Applying the guidelines in their current form will lead to volatility in pricing because the rate of return on investment forms a significant component of prices for water services. They reflect an approach which focusses on economic theory to the exclusion of consumer preference for pricing stability. Lower volatility to rate of return and, as a consequence prices, could be introduced by adopting a form of trailing average portfolio approach to determine the cost of debt. It is our understanding that both customers and Government would prefer more stable and consistent prices over time to facilitate budgeting at household, small business and State Government levels.

We actively seek private sector investment in water service assets as a means of sourcing innovation and efficiency, which provides a complementary source of funding for Government, which is focused on fiscal and debt restraint. The private sector needs higher and less volatile rates of return than those resulting from the current regulatory approach in the current market to support investment in long-lived assets. This supports taking a longer term view of the cost of funds for determining prices for services.

The establishment of an appropriate rate of return is fundamental to setting customer prices and ensuring the ongoing viability of both the Water Corporation and the provision of water services in Western Australia. Investments in water services infrastructure such as dams and pipelines, complex treatment plants and simple wastewater ponds, sewers and drains can last for 100 and more years. The return on investment, being the weighted average of the cost of debt and cost of equity multiplied by the regulatory asset base forms a significant component of prices for water services. The current approach to determining regulated rates of return incorporates short term volatility of financial markets. This volatility is reflected in prices for services and is not in the long term interests of consumers.

If you require any further clarification or have any questions please do not hesitate to contact Deb Evans on (08) 9420 2451 or via email deb.evans@watercorporation.com.au.

Yours faithfully

[redacted]

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