

18 August 2017

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



Dear Dr Boxall,

Review of IPART's WACC method issues paper

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) method. PIAC limits its comment 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 a positive outcome for consumers, yet stresses the importance of keeping WACC no higher than absolutely necessary, particularly in the interest of supporting affordability and allowing households to budget effectively for the essential service of water.

Keeping consumer impacts at the centre of discussions

Consumer impacts are central to any regulatory decisions and must remain front of mind in any discussion regarding the process and method for regulatory determinations. For instance, the *IPART Act 1992* (NSW) states that IPART must have regard to "the protection of consumers from abuses of market power, ... the need for greater efficiency in the supply of services so as to reduce costs for the benefit of consumers and taxpayers, ... [and] the social impact of the determinations and recommendations."¹

While WACC, and hence the method of calculating it, plays a significant role in the bills that consumers ultimately pay, it can be an arcane and inaccessible subject for consumer advocates to provide comment on and posit consumer preferences in potential outcomes. There is also a risk that stakeholders may lose sight of the ultimate role of WACC in regulatory price and revenue determinations and instead be caught up in an academic or technical debate over which method or model is inherently 'better.' The more important consideration is the defensibility of any assumptions used in developing inputs into the model.

Therefore, PIAC recommends that IPART emphasises the impact on consumers from any changes to the WACC method in this review. This should help to frame the debate to ensure

1 *Independent Pricing and Regulatory Tribunal Act 1992 (NSW)*, S15

that the WACC methodology is, indeed, working in the best interests of consumers.

For instance, IPART could develop one or a number of representative price determinations to demonstrate the impact of any proposed change in WACC methodology that may be applied. This may also require several economic scenarios to capture the impact of, for instance, different movements in financial markets. Doing so would allow stakeholders to better compare the effect of any proposed changes against a counterfactual, the current WACC method, and understand the need for any changes. We expect that regulated businesses would conduct similar modelling on the impact to their own businesses, but this is not practical for consumers and consumer advocates to do for the multiple businesses that IPART's WACC method would apply to. While PIAC appreciates the potential complexity of this, we are of the view that this would be very useful and worthwhile.

Predictability of price outcomes

The predictability of price outcomes is important to many consumers – but especially low-income and vulnerable households. Therefore, in considering changes such as updating the cost of debt within period, it is important that IPART and stakeholders must consider whether yearly, incremental changes or greater potential step changes at the start of each period provides the most predictable price outcomes which the business' consumers can respond to.

PIAC considers that gradual, consistent, incremental changes in prices would generally be more preferable than larger step changes. The predictability of this change would better allow consumers to budget for these costs. For instance, if prices were to materially transition from one level to another across a number of years, PIAC would prefer a consistent, year-on-year change between these two levels over a large step change in a single year.

Further, PIAC would also prefer that any volatility between each year in the factors underpinning prices be smoothed out rather than passed through to customers in the form of erratic price fluctuations, as long as any risk premium or additional interest that is incurred in making such smoothing does not in itself impose materially higher costs on consumers.

Using a 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 (such as raising debt in staggered increments) as a guide to developing the efficiency benchmark to ensure that the defined BEE is reflective of current business practices.

However, central to the appropriateness of the BEE is that the risk and cost profile must be similar to that of a regulated business. Experience indicates that caution should be exercised in broadening the range of businesses in the set of comparator businesses such as including businesses operating in competitive markets. Simply adding more entities to the sample may make the data more statistically reliable but may also make the comparison less valid.

While PIAC is not suggesting that IPART's BEE is inappropriate, we stress the importance of validity (relevant samples) over and above statistical reliability (larger sample sizes).

Developing an appropriate value for gamma

PIAC understands that, given the post-tax WACC approach that IPART employs, IPART does not directly use gamma in its calculations but it does affect the calculation of the Market Risk Premium (MRP).

Despite the potentially minor impact of gamma on price outcomes, PIAC is concerned that the value of gamma used by IPART is significantly lower than that used by other regulators as noted in Appendix A of the Issues Paper. In the Issues Paper, IPART has noted that its current value of gamma is based on work done by SFG Consulting for the Australian Competition Tribunal in 2011 and more recently for energy network businesses in 2015. However, the Australian Competition Tribunal since found in favour of the AER's calculation of a gamma of 0.4 in its decision regarding SA Power Networks,² as did the Full Federal Court with respect to the AER's decision regarding the NSW and ACT DNSPs.³

PIAC therefore recommends that IPART review its calculation of gamma and reconsider whether it should continue to use a value of 0.25 as proposed.

Continued engagement

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

Yours sincerely,

Craig Memery

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Public Interest Advocacy Centre



2 Australian Competition Tribunal, *Final decision on Application by SA Power Networks*, 2016

3 Federal Court of Australia, *Australian Energy Regulator v Australian Competition Tribunal (No 2)* [2017] FCAFC 79, 2017