SA Water

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Mr Nathan Petrus
Essential Services Commission of SA
GPO Box 2605
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Dear Mr Petrus

SA Water welcomes the opportunity to respond to the Essential Services Commission of South Australia's *Advice on a Regulatory Rate of Return for SA Water*, released on 6 December 2011.

Although we acknowledge that the public release of the advice on the rate of return does provide some direction as to likely future impacts of economic regulation upon SA Water and its customers, a greater level of clarity is sought as detailed below.

Methodology

SA Water notes that the overall methodology for establishing the regulatory rate of return is based upon a pre-tax weighted average cost of capital (WACC), with the cost of equity derived from the Capital Asset Pricing Model (CAPM). This methodology is broadly consistent with that used by the Government in recent water and wastewater pricing decisions and is in line with the general consensus of regulators interstate.

The variations in the above WACC estimates are primarily driven by market related factors:

- The risk free rate on Commonwealth bonds.

  10 year Commonwealth bonds are trading at yields well below their long term average.

- The debt risk margin on traded BBB debt securities.

  Debt margins on traded BBB securities have increased significantly since the Global Financial Crisis in 2007.

- Impact of imputation credits (gamma)

Government
of South Australia

While the methodology used by ESCOSA is generally consistent with previous practice, there are a number of items which SA Water notes could result in a different WACC outcome:

1. The term and timing of the sample period for observable inputs.
2. The methodology used for determining the debt risk margin.
3. The level of the equity beta.
4. The debt to total capital ratio applied.

Sample period for observable inputs

ESCOSA have adopted a 20 day period for observable market inputs to the WACC. This averaging period is very short and makes the estimate susceptible to short term market volatility. Longer term periods (i.e. 40, 60 or 90 days) may eliminate some of the "noise" in the data around the time the WACC is set. This issue has been recognised in numerous interstate regulatory decisions, however regulators have continued to adopt 20-day averaging periods at the time of regulatory decisions.

The observable market inputs have been highly volatile in recent years; therefore the particular timing of the sample taken has a material impact on the WACC outcome.

Section 2.2 of the Commission's draft advice notes that the rate of return is based upon a number of market variables and that "it is the highly likely that the rate of return recommended in this draft advice will be different to that recommended in the Commission's final advice, due mid-February 2012"

SA Water Position
It is recommended that ESCOSA adopt longer period for observable inputs to reduce volatility.

Debt risk margin

ESCOSA have extrapolated the 7 year Bloomberg fair value curve for BBB to BBB+ rated debt securities to a 10 year curve and applied it to determine the debt risk margin.

Since the GFC in 2007 the number of BBB rated securities with long terms to maturity (>5 years) has reduced dramatically. The Bloomberg fair value curve beyond 5 years is now very thin and includes only 3 companies (Sydney Airport Finance, Mirvac and Dalrymple Bay Coal Terminal). The curve is therefore subject to an inappropriate level of influence from company specific factors.

Interstate regulators have elected to adopt either the 5, 7 or 10 year Bloomberg fair value curves and/or to supplement them with securities of companies from similar industries to the entity being regulated. A broader suite of securities would generally result in a lower debt margin and lower WACC.

SA Water Position
It is recommended that ESCOSA utilise a methodology that includes a broader range of observable debt instruments

Equity beta

ESCOSA have applied an equity beta of 0.8, which is applied to market risk premium and added to the risk-free rate to derive the cost of equity component of the WACC. In IPART's final determination of Sydney Water prices their decision was to employ a higher equity beta range of 0.8 to 1.0 (using the mid-point in its WACC estimate). IPART recognised that if Sydney Water's revenue risks and risks from water restrictions are systematic in nature, it may potentially face higher risk.

Given the differing positions taken by interstate regulators on equity beta, it would appear appropriate to retain the 0.8 value that has been used historically.

SA Water Position
SA Water support the use of an equity beta level of 0.8 and recommend that it be maintained for the calculation of WACC for the 2013 -2016 pricing determination.

Debt to total capital ratio

ESCOSA have applied a debt to total capital (gearing) ratio of 60%. Gearing ratios of 50%-60% have historically been used by regulators as they represented the average gearing of efficient private sector businesses with a BBB rating.

It is noted that ESCOSA's benchmark gearing assumption of 60% debt to total regulatory assets is adopted almost uniformly by Australian regulators.

SA Water Position
SA Water support the assessment of a 60% gearing level and recommend that it be maintained for the calculation of WACC for the 2013 -2016 pricing determination.

Consistent Application of Methodology

The Commission's Final Advice on the regulatory rate of return is to be considered by the Treasurer for the purpose of developing a pricing order for SA Water's first regulatory period, effective from 1 July 2013. Section 1.1 of the Commission's Draft Advice, implies that the regulatory rate of return may require to be updated for the 2013-16 pricing determination. SA Water is of the view that the pricing order and the 2013-16 pricing determination should be based on the same regulatory rate of return.

SA Water Position
It is recommended that the WACC used for 2013-16 pricing determination be consistent with that used for development of a pricing order for SA Water's first regulatory period

SA Water welcomes any clarity in relation to aspects of the regulatory framework. We will continue to work closely with ESCOSA to ensure that benefits of economic regulation are realised for SA Water's customers.

Yours sincerely,

John Ringham
Chief Executive