Attachment 3

Other matters

December 2022

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3.1 Introduction

This attachment sets out Icon Water's response on the Independent and Regulatory Commission's (the Commission's) assessment in their Draft Decision of:

- the Weighted Average Cost of Capital (WACC)
- form of control, including pass through events
- demand forecast.

This attachment also includes our views on the pass through of costs for new non-controllable operating expenditure (opex) categories proposed by the Commission, and the Draft Decision to review wastewater tariffs as a reset principle.

We also ask the Commission to update inflation for 2022–23 based on the most recently available information at the time of the Final Decision. The Commission's draft decision used a placeholder estimate for 2022–23 based on forecast inflation, which should be updated to reflect actual/expected inflation before making its final decision.

Box 3-1: Key points

- Icon Water agrees with the Commission's Draft Decision for the WACC. Our revised revenue requirement provided as part of our response to the Commissions' Draft Decision includes an updated WACC estimate. We note that the Commission will update the WACC again before its final decision.
- Icon Water agrees with the Commission's Draft Decision to review wastewater tariffs as a reset principle.
- Icon Water agrees with the Commission's Draft Decision on the demand forecast.
- Icon Water agrees with the Commission's Draft Decision to treat some costs including regulatory compliance costs, licence fees and royalties as non-controllable operating costs. However, we consider these costs should be 'trued-up' to be consistent with other non-controllable operating costs.

3.2 Rate of return

3.2.1 The WACC Draft Decision

The Commission's Draft Decision largely accepted Icon Water's proposed WACC, including our proposed debt averaging periods. The Commission did not accept Icon Water's proposed value of imputation credits of 0.25 and instead adopted a value of 0.50.

The Commission adopts a benchmarking approach to determine the WACC and the Draft Decision largely reflects positions put forward in a recent review of the WACC which was undertaken as a reset principle in the current regulatory period.[1]

In our submission we estimated a WACC of 5.11 per cent using a placeholder estimate for market risk premium (MRP) of 6.1 per cent, consistent with the Australian Energy Regulator's (AER) 2018 Rate of Return Instrument (RORI). The Commission noted Icon Water's position that the WACC should reflect current benchmark data. Consistent with this, in its Draft Decision the Commission updated the WACC estimate proposed by Icon Water to 5.93 per cent, reflecting the MRP the AER included in its draft determination for the 2022 RORI released in June 2022.

In its Draft Decision, the Commission further considered the AER's RORI draft determination as well as other evidence and determined a WACC of 5.85 per cent, using an MRP of 6.5 per cent, representing parameters derived using the benchmarking approach. Icon Water accepts this Draft Decision on the WACC.

The WACC parameters determined by the Commission in the Draft Decision and accepted by Icon Water are set out in Table 3-1.

Table 3-1: Weighted average cost of capital parameters

Parameter	2018 Decision	Icon Water proposal	Draft Decision	Revised proposal
Risk free rate	2.8%	2.2%	3.38%	3.82%
Debt raising costs	0.125%	0.108%	0.108%	0.108%
Equity beta	0.7	0.7	0.7	0.7
Market risk premium	6.5%	6.1%	6.5%	6.5%
Gearing ratio	60%	60%	60%	60%
Return on equity	7.34%	6.51%	7.93%	8.37%
Return on debt	4.75%	4.20%	4.46%	4.54%
Nominal post-tax vanilla WACC	5.78%	5.11%	5.85%	6.07%
Value of Imputation credits	0.4	0.25	0.50	0.50

Source: Icon Water.

The remainder of this section discusses information that Icon Water submits the Commission should consider and incorporate into the final decision.

[1] ICRC, *Final Report, Review of Methodologies for the WACC*, April 2021

Risk-free rate

The risk-free rate reflects the return an investor would expect in the absence of default risk. The Commission's Draft Decision includes a placeholder risk-free rate of 3.38 per cent noting it will update before the final decision. Our revised proposal reflects an updated risk-free rate, which is higher than the value used for the Draft Decision.

The Commission calculated its estimate of the risk-free rate using the methodology set out in the 2021 WACC review, which is to reflect data for a period of 40 business days as close as possible to the start of the 2023–28 regulatory period. Icon Water agrees with this approach.

Debt raising costs

Icon Water accepts the Commission's Draft Decision for a debt raising cost allowance of 0.108 per cent, as proposed by Icon Water.

Equity beta

The equity beta adjusts the market risk premium to reflect the risk of the entity, in this case Icon Water, to the broader market. The Commission benchmarked values used by other Australian regulators for the equity beta, giving greater weight to more recent decisions. The Commission accepted Icon Water's proposed equity beta of 0.7, which was consistent with the value it found reasonable in its 2021 WACC review.

Market risk premium

The MRP is the expected return by which a market portfolio exceeds the risk-free rate. The Commission considers a broad range of methods to estimate the value of the MRP including historical estimates and dividend growth models (DGM). The Commission favours using arithmetic averages when estimating historical excess returns and cautions against using estimates heavily based on dividend growth models.

In its Draft Decision, the Commission considered a range of recent regulatory estimates for MRP and noted the mix of methods (historical estimates and DGM) used. Icon Water supports the benchmarking approach the Commission used to estimate the MRP and accepts the MRP estimate of 6.5 per cent.

Icon Water notes that one of the regulator estimates used was the AER draft decision for the 2022 RORI, released in June 2022. In November 2022, the AER notified stakeholders that it will delay its final decision on RORI until February 2023[2] to consider further evidence regarding the potential impacts of recent quantitative easing and other monetary policies associated with the post-Global Financial Crisis period on the AER's standard approach to estimating the market risk premium using a historical excess returns approach.

We are concerned that the AER's review may introduce data unavailable to other regulatory bodies and, given the limited time between its expected release and the Commission's final decision, it will not give stakeholders sufficient time to consider its implications if it is included in the benchmark approach. Icon Water considers the existing draft decision released by the AER in June 2022 is the most appropriate input to the benchmark approach for estimating MRP.

Return on debt

The value of the return on debt is a methodological process determined using nominated data sources and averaging periods. In 2018 Icon Water proposed and the Commission accepted a change to the

[2] See AER Website: https://www.aer.gov.au/publications/guidelines-schemes-models/rate-of-return-instrument-2022/draft-decision

trailing average method for estimating the return on debt and in 2022 Icon Water proposed this approach continues.

The Commission uses a benchmarking approach to set the benchmark credit rating and we accept the Draft Decision where a BBB credit rating is used. The return on debt is the simple average of two third-party data series, Reserve Bank of Australia (RBA) and Bloomberg, for 10-year BBB yields corporate bonds.

Icon Water submitted a return on debt averaging period consistent with the Commission's WACC methodology and the Commission accepted this averaging period.

<u>Proposed value for imputation credits</u>

The value of imputation credits is a factor in the revenue building block model to account for the value of imputation (or franking) credits when making an allowance for corporate tax.

The Commission analysed the approach other Australian regulators use to set this allowance and the value of this allowance. The Commission decided to use the utilisation method to set gamma, compared with the market value concept proposed by Icon Water. In making this decision the Commission noted the arguments put forward by Icon Water in support of the market value method and considered the analysis of other Australian regulators and concluded the utilisation method represents the approach used by most other regulators. The Commission determined a value of 0.5 for imputation credit.

While Icon Water disagrees with this position, we accept the Draft Decision to value imputation credits at 0.5 for this regulatory period as it will result in lower prices for customers in the short term.

3.3 Water and wastewater tariffs

The Commission made a Draft Decision to:

- retain the two-tier inclining block water tariff structure and apply price changes uniformly across all water tariff components
- maintain the existing wastewater tariff structure, comprising a fixed annual supply charge for all customers, and a flushing fixture change applying to non-residential customers
- conduct a review of the wastewater tariff structure over the next regulatory period. This is given effect through a reset principle in the price direction.

Icon Water agrees with the Commission's approach, including the Draft Decision to undertake a future review of the structure of wastewater tariffs in the ACT.

Our regulatory proposal submitted in June 2022 proposed to retain the current water tariff structure. To inform this proposal, we undertook a comprehensive engagement process, including asking our customers about the current tariff structure and their preferences for possible future structures. We found that while some customer segments strongly supported continued tariff rebalancing and/or introducing a non-residential tariff, there was not a broad level of support across all customer segments to pursue changes at this time.[3] Therefore, we proposed to retain the current wastewater tariff structure.

Our regulatory proposal submitted in June 2022 also outlined the work we are undertaking to better understand the impact of liquid trade waste (LTW) on our network and the associated costs to inform how we can best manage LTW in a way that protects our people and assets, while delivering a fair outcome for customers.[4] This work will continue into the 2023–28 regulatory period to inform the Commission's review of wastewater tariffs.

We acknowledge that some non-residential customers, particularly those in the hotel and accommodation sector, feel the flushing fixture charge is too high and does not reflect their impact on the wastewater network, particularly when compared to residential customers.[5] The current wastewater tariff structure, with a flushing fixture charge for non-residential customers, is designed to approximate the volume of wastewater produced by different customers and their associated impacts on the wastewater network. The design reflects the fact that Icon Water cannot accurately measure wastewater discharges for individual customers at this time.

During the 2023–28 regulatory period, Icon Water will continue its investigations into LTW[6]. This is expected to provide a better understanding of non-residential discharges, their impacts, and how Icon Water can manage these discharges. This may include the potential for new wastewater pricing options. We look forward to working with the Commission and stakeholders as part of the future review of wastewater tariffs.

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[3] Icon Water, *Price Proposal - Attachment 12, Tariff structure and proposed prices*, 30 June 2022, p. 14

[4] Icon Water, *Price Proposal - Attachment 1, Our role, operations and business context*, 30 June 2022, p. 29

[5] For example, see Australian Hotels Association and Accommodation Association, *Regulated Water and Sewerage Service Prices 2023-28, submission to the Independent Competition and Regulatory Commission's Issues Paper*, 8 April 2022: https://www.icrc.act.gov.au/__data/assets/pdf_file/0010/1996516/Australian-Hotels-Association-and-Accommodation-Association.pdf

[6] It is expected that Icon Water's risk-based management of LTW customers will continue throughout the 2023–28 regulatory period, although practices may be refined based on the results of these investigations.

3.4 Demand forecast

The Commission's Draft Decision accepted Icon Water's approach to forecast water and wastewater services demand, but updated data inputs into the demand forecasting model. The Commission will update the demand forecast again before making its final decision.

The demand forecast in our proposal adopted the methods set out in the 2021 decision by the Commission on demand forecasting methodologies.[7]

To determine the prices Icon Water can charge, the Commission divides Icon Water's revenue requirement by a forecast of demand for the five-year regulatory period. Some components of Icon Water's revenue requirement are also calculated using the demand forecast.

For each regulatory period, Icon Water must develop forecasts for four demand components which are directly used to set water and wastewater prices:

1. dam abstractions
2. billed water sales
3. connection numbers and wastewater billable fixtures
4. wastewater volumes

Forecasting water demand can involve a degree of uncertainty, especially on shorter timescales when demand is highly influenced by the weather. The Commission applies a demand 'deadband' mechanism to help appropriately share the risk of demand volatility between Icon Water and customers.

<u>We agree with the Commission's Draft Decision</u>

We have reviewed the approach the Commission used to forecast demand for the 2023–28 regulatory period. We agree with the Commission's approach, which is consistent with its 2021 decision on demand forecasting methodologies.

We note, however, that we were unable to exactly replicate the water volumes forecast. We suggest this slight difference may be due to a missing data observation for dam abstractions on 3 May 2022, which we included in our analysis.

[7] ICRC, *Final Report: Review of water and sewerage services demand forecasting methods*, 2021

3.5 Pass through of non-controllable operating expenditure

The Commission made a Draft Decision to accept the recommendation made by Marsden Jacobs Associates (MJA) to treat some additional opex costs (including regulatory compliance costs, the Commission's price review costs, licence fees and royalties) as non-controllable.

Non-controllable opex captures costs that are outside our control and are trued-up annually through a pass-through provision. Non-controllable opex includes the Water Abstraction Charge (WAC) and the Utilities Network Facilities Tax (UNFT), which reflects ACT Government fees and charges.

As outlined in Attachment 1, we agree with the Commission's Draft Decision that these opex costs could be treated the same as other non-controllable costs such as the UNFT and WAC. The Commission's Draft Decision is not entirely clear, but to avoid doubt we consider there is a need to clarify that these costs will also attract an annual true-up, to ensure they are treated consistently with other non-controllable costs.

This approach recognises that the costs are not within Icon Water's control and should reflect actual costs in each year of the regulatory period. Under this framework, customers do not pay more than is necessary to recover the costs to pay taxes, fees and charges recovered through regulated water and wastewater prices.

Within the Commission's regulatory framework this means our revised proposal reflects a forecast of non-controllable costs, but this forecast is updated with actual costs when prices are adjusted annually to reflect new information for some variables. Not providing an annual true-up for these costs would be inconsistent with the Commission's treatment of other non-controllable operating costs and could mean that customers pay too much if taxes, fees and charges are lower than forecast. We support classifying these costs as non-controllable only on the basis that there is an annual true-up.

Abbreviations and acronyms

AER	Australian Energy Regulator
Commission	Independent Competition and Regulatory Commission
DGM	dividend growth models
LTW	liquid trade waste
MJA	Marsden Jacobs Associates
MRP	market risk premium
opex	operating expenditure
RBA	Reserve Bank of Australia
RORI	Rate of Return Instrument
UNFT	Utilities Network Facilities Tax
WAC	Water Abstraction Charge
WACC	Weighted Average Cost of Capital