energy networks association

AER REVIEW OF THE WEIGHTED AVERAGE COST OF CAPITAL

The Network Industry's response to the AER's proposed statement of the Weighted Average Cost of Capital (WACC) parameters for electricity transmission and distribution networks, February 2009, submitted that the AER consider its approach and address the following deficiencies:

- apply the 'persuasive evidence' test properly (among other things); and
- fully and properly consider the present and emerging effects of the global financial crisis on the cost of capital.

The Financial Investor Group's submission to the AER, January 2009 also contains expert opinion and evidence that there is not persuasive evidence to support the AER's changes to WACC parameters.

This document provides additional information on the critical considerations for the review, having regard to the continued and deepening severity of the Global Financial Crisis (GFC).

The key points are:

1. There is no doubt that extraordinary circumstances apply to current debt and equity markets. While the Rules require a rate of return to be set which is both forward looking and commensurate with market conditions, these requirements cannot be reconciled in the midst of an economic crisis.
2. It is impossible at this stage to determine when markets will revert to more normal conditions. The key issue for the AER is how to reconcile market evidence which suggests that the current costs of both equity and debt are higher, rather than lower as set out in the proposed statement of WACC parameters. Any response should, as a minimum in these circumstances, not change the WACC parameters even though this would not capture increases in the cost of capital already evident.
3. The uncertainty in accurately estimating the cost of equity and the cost of debt caused by the GFC means that there is no persuasive evidence to depart from values currently adopted to set the rate of return.
4. To retain the current WACC parameters would increase regulatory certainty for the industry during the GFC. Once capital markets stabilise, the AER may consider it appropriate to undertake another review of required rates of return. There is nothing in the Rules to stop the AER from undertaking a further review of parameters for distribution businesses earlier than the 5 years stipulated. However, to allow this earlier review to apply to transmission businesses, a rule change would be required (Transmission Rules stipulate a 5 year review).

1. **While the Rules require a rate of return to be set which is both forward looking and commensurate with market conditions, these requirements cannot be reconciled in the midst of a financial crisis.**

- In undertaking its review of the individual WACC parameters, the AER must have regard to[1] (among other factors) the need for the rate of return to be a **forward looking rate of return** that is **commensurate** with **prevailing conditions in the market** for funds and the risk involved in providing direct control services.
- The GFC has made it extremely difficult to determine parameters that are consistent with both a forward looking rate of return and a rate of return commensurate with prevailing market conditions.
- The deepening GFC has resulted in abnormal observations in the values used to set the rate of return. These include:
    - Higher return on equity (driven by a flight from equity) while the nominal CGS yields has reached unprecedented low levels. The result is a very depressed estimate of the current cost of equity.
    - The financial crisis has severely impacted the functioning of debt markets and market observable rates (risk free rate and debt risk premiums) are not actually trading results and not available to network owners. The market is illiquidity and distorted by Government trading.
- The AER must not only decide whether there is sufficient evidence to persuade it to move away from existing parameters using criteria that seem irreconcilable (forward looking and prevailing), it also needs to decide how long the GFC will last and how much better/worse it will get.
- If AER ignores the GFC, it is deciding that the impact will be relatively brief and will not impact average rates of return during the period to the next review even though contrary expert opinion has been submitted to the AER.

2. **If the AER cannot reconcile CAPM outcomes with market conditions, any response should, as a minimum in these circumstances, *not* change the WACC parameters even though this would not capture increases in the cost of capital already evident.**

- Where values for parameters cannot be determined with certainty, the AER must have regard to the need for **persuasive evidence** before adopting a value that differs from the value that has been previously adopted.
- Persuasive evidence is difficult to establish in stable markets, and this difficulty is accentuated in periods of high uncertainty, causing the theoretical application of the CAPM to derive parameters that are clearly not in evidence in the market. Evidence to move parameters commensurate with market conditions has been provided in detail submissions.
- As a minimum, given the significant uncertainty in markets, it is open for the AER to declare that there is insufficient evidence to persuade it to move parameters in either direction and meet the need to establish a forward looking rate of return commensurate with prevailing market conditions.

[1] Must have regard to "Having regard to" means to take each of the stipulated factors into account and give them weight as fundamental elements in making its decision. It is not open to the AER to consider but not to give weight to any of the factors.

3. There is nothing in the Rules to stop the AER from undertaking a further review of parameters earlier than the 5 years stipulated

- Under distribution Rules, the AER is not restricted to review WACC parameters at strict 5 year intervals. The AER can undertake a review at anytime as long as the interval between reviews does not exceed 5 years.
- Transmission Rules do not afford the AER the same flexibility. The AER could seek a Rule change that would allow Transmission Rules to be consistent with distribution Rules and allow the AER to undertake a review earlier than 5 years.

By applying parameters previously applied in the Rules as part of its statement of regulatory intent, the AER can avoid forecasting the length and depth of the current financial crisis and with the assistance of a Rule change, undertake a further review when market conditions return to a more normal state.

19 March 2009