

22 September 2008

Mr Chris Pattas
General Manager
Network Regulation South Branch
Australian Energy Regulator
GPO Box 520
Melbourne Vic 3001

Dear Chris,

**Review of the weighted average cost of capital (WACC)
parameters applicable to electricity transmission and distribution**

Overview

The Australian Energy Regulator's (AER) review of the weighted average cost of capital (WACC) parameters applicable to electricity transmission and distribution networks is occurring at a unique stage in the evolution of the regulatory framework for the electricity sector. Past reforms have led to the development of a world leading wholesale electricity market, with highly efficient generation, network and retailing segments. With the AER now taking responsibility for setting distribution as well as the transmission WACC parameters outside of each business's specific reset determination, the vision for the original regulatory reform is almost complete. For the first time a truly national approach to network investment signals can be created, the importance of which cannot be under emphasised.

The Energy Networks Association (ENA) represents energy network businesses which deliver electricity and gas to over 13 million customer connections across Australia through approximately 800,000 kilometres of electricity distribution lines. There are also 76,000 kilometres of gas distribution pipelines. These distribution networks are valued at more than \$40 billion and each year energy network businesses undertake investment of more than \$5 billion in distribution network operation, reinforcement, expansions and greenfields extensions.

The ENA welcomes this opportunity to provide a submission to the AER's WACC parameter review. In doing so it acknowledges its full support for the Joint Industry Associations' submission prepared in conjunction with GridAustralia and the Australian Pipeline Industry Association. The Joint Industry Associations' submission brings together the best available independent analysis of the evidence relating to each of the WACC parameters, highlights the importance of this review to the industry as well as the importance of this industry to the economic well being of the Australian population and national prosperity.

In this submission the ENA sets out its views on:

- The need for increased network investment.
- The importance of the WACC parameters to securing needed investment.
- The challenges network businesses face for efficient network investment.
- The proposed WACC parameters.

The need for increased network investment

Over the forthcoming regulatory control periods there will be a need for increased network investment. This investment is being driven by:

- Increasing demand for electricity from Australian businesses and households, particularly during network peak periods.
- A need to support energy intensive export businesses, which are driving network demands particularly in regional and remote locations.
- A need to replace ageing infrastructure.
- A need to maintain security of energy supplies.

In addition, there is likely to be a step change in demand for network services following policy measures to address climate change, which is anticipated to change the pattern of network use, in turn affecting both the location and timing of network investments. At this time it is difficult to predict what additional network investment this might require as there is inherent uncertainty about likely responses to climate change policies, and there is also considerable uncertainty surrounding likely community adaptation to long term climate variability, which affects network demand forecasts. It is this uncertainty that creates new and unpredictable financial risks for network businesses in addition to the risks that our members have routinely been required to confront.

The regulatory framework for determining WACC parameters and the allowed rate of return plays a crucial role in providing incentives to network businesses to undertake efficient investment. A central part of the framework is an obligation for the AER to take into account the need to achieve an outcome consistent with the national electricity objective¹, namely, the promotion of efficient investment in electricity services for the long term interests of consumers, taking into account system security and network reliability².

Ensuring that the regulatory environment secures efficient network investment in this critical infrastructure sector is therefore vitally important³. It is the AER's approach to reviewing the WACC parameters, and varying currently adopted parameter values that combine to provide the necessary incentives to promote efficient network investment.

The importance of the WACC parameters in securing network investment

There are inherent risks associated with network asset investment arising from the long-lived nature of the assets, and the consequent lengthy payback period of up to 40 to 50 years. The current WACC parameter review will provide investment incentives over the next 10 years. Ensuring that the parameters lead to a stable and predictable allowed rate of return will go a long way towards promoting efficient investment.

¹ NER 6.5.4(4)(i) for distribution and 6A.6.2(j)(4) for transmission.

² Section 7, National Electricity Law.

³ Critical energy infrastructure refers to those facilities, supply chains, information technologies and communication networks within the liquid fuels, gas and electricity sectors, which, if destroyed, degraded or rendered unavailable for an extended period, would adversely impact on the social or economic well-being of the nation or affect Australia's ability to ensure national security, (Department of Resources, Energy and Tourism, 2008).

In undertaking the review the AER should therefore be mindful of:

- Ensuring that the WACC parameters reflect the best available market evidence, so that the consequent allowed rates of return are sufficient to at least compensate investors for the risks associated with network investment, particularly taking into account that the risks facing networks are increasing.
- The importance of establishing a precedent in this review (which is the first of its kind under the rules) that delivers a strong sense of regulatory certainty and consistency across jurisdictions.

In undertaking its review, the AER should therefore be cognisant of the potential risk of network underinvestment that could result from either the overall rate of return being inadequate to attract investment, or if the AER perpetuates regulatory uncertainty through a lack of clarity in its reasoning and approach to any variations in currently adopted WACC parameters. While the framework for changing WACC parameters has been designed to improve regulatory certainty by directly requiring parameter changes to be linked to persuasive evidence, the way in which the AER conducts the review will also be important in contributing to regulatory certainty.

The challenges for efficient network investment

There are a number of challenges emerging that have implications for the incentives created for efficient network investment. These challenges include:

- Uncertainty in the availability of finance as a result of current financial market turmoil, which is expected to result in increased competition throughout the wider economy for the limited funds available.
- An increased need for new network investments, driven by continuing growth in electricity demand particularly during peak periods.
- An anticipated need to redesign the electricity network resulting from incentives created by policies designed to lower greenhouse gas emissions, leading to some network redundancy and new network requirements.

Financial market turmoil is leading to practical concerns that accessing funds for increasing network investment expenditures will become more difficult. As competition for limited funds increases, investors will increasingly examine the relative returns of similarly risky investments. Ensuring that network businesses earn a return that is sufficient to fund new investment is therefore critical, with associated implications for network reliability and security.

Increasing growth in electricity demand, particularly during peak periods, is resulting in increasing network demand. The challenge for network businesses will therefore be to maintain reliability and system performance standards through increased network investment in circumstances where funding may be limited.

Finally, the introduction of the Carbon Pollution Reduction Scheme and the expansion of the national renewable energy target are expected to change the pattern of use of the network as new generating units are constructed in different parts of the network. The precise implications for network investment are inherently uncertain, as it will depend on changes in distributed generation and renewable generation technologies, and the relative costs of each type of generation.

That said it is likely that there will be a need for new network investment in some locations, and redundancy of parts of the existing network in other areas. The result will likely be increased financial uncertainty as network businesses prepare to respond to new network needs.

Proposed WACC parameters

The ENA fully supports the analysis and conclusions drawn in the Joint Industry Associations' submission. In particular the ENA supports the conclusion that there is no evidence to support a shift away from previously adopted parameter values for most WACC parameters.

However, there are two areas that the AER should closely consider, namely:

- In relation to beta, '1' is the figure which best meets the description of a 'previously adopted' value and there is no persuasive evidence to depart from a value of '1'. For a minority of our distributors, their jurisdictional regulators have most recently adopted a '0.9' and if this were considered to be the relevant 'previously adopted value' (and to be clear the ENA does not consider this to be true), there is persuasive evidence that '0.9' is too low a beta and an unsafe figure which is at significant risk of failing to satisfy the requirements of the National Electricity Law; and
- There is persuasive evidence that gamma and/or the market risk premium should be modified, in accordance with the most recent evidence as set out in the Joint Industry Associations' submission. The current values for these two parameters are inconsistent as imputation credits (a component of gamma) is attributed a value to a regulated firm but not to the market in general. Adopting a consistent approach leads to a higher value for the market risk premium.

Importantly, the ENA expects that the combined package of parameters adopted by the AER will provide for an efficient cost of capital that appropriately takes into account the economic theory and evidence, relationships between parameters, market expectations on the return to equity, prevailing market conditions for debt raising, and finally the national electricity objective. This is expected to ensure that allowed rates of return are adequate to support network investment needs.

Finally, the ENA's approach to the AER's WACC review has been measured and responsible, acknowledging the implications for regulatory certainty of the review outcomes. In light of the network investment challenges that are emerging, it is critically important that the regulatory framework provide certainty and predictability about the allowed rate of return. This review is essential to ensuring that occurs.

Please contact me should you wish to discuss this matter further.

Yours sincerely,



Andrew Blyth
Chief Executive