ETSA Utilities

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Mr Chris Pattas
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Network Regulation South Branch
Australian Energy Regulator
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Dear Chris

AER Review of WACC parameters for Electricity Transmission and Distribution

ETSA Utilities, Powercor and CitiPower (the businesses) welcome the opportunity to provide a submission to the Australian Energy Regulator (AER) on its review of the weighted average cost of capital (WACC) parameters applicable to electricity transmission and distribution businesses.

ETSA Utilities operates and maintains the only significant electricity distribution network in South Australia, supplying safe and reliable energy to over 796,000 customers throughout major metropolitan areas, including the capital city of Adelaide. With more than 60 years' experience, ETSA Utilities is one of the State's largest organisations employing over 1670 people, with operations spanning 178,000 square kilometres and 28 depots around the State. The ETSA Utilities network is among the most reliable in Australia, with a network availability rating of 99.97%.

Powercor Australia is the largest distributor of electricity in Victoria, owning and operating a network that serves over 680,000 customers in central and western regional Victoria and the Western suburbs of Melbourne. CitiPower owns and operates the distribution network that supplies electricity to over 300,000 customers in Melbourne's CBD and inner suburbs. Powercor and CitiPower's operations span approximately 150,000 square kilometres, employing around 1700 people. The Powercor and CitiPower networks operate at network availabilities of 99.96% and 99.99% respectively.

ETSA Utilities, Powercor and CitiPower are 51 percent owned by Cheung Kong Infrastructure Holdings Limited and Hongkong Electric Holdings Limited, which form part of the Cheung Kong Group of companies. The remaining 49 percent is owned by Spark Infrastructure Group, which began trading on the Australian Stock Exchange in December 2005.

At the outset, the businesses wish to express their full support for the conclusions contained within the ENA, APIA and Grid Australia joint industry association's submission. The joint association submission contains the most comprehensive and up to date analysis and evidence on each of the parameters being considered as part of the review. The businesses commend it to the AER as representing the best evidence available at this time.

This submission sets out the businesses' views on:

- the current WACC parameters and the absence of any evidence of 'over-investment' in existing networks;
- the challenges facing distributors as they seek to provide reliable network services into the future; and
- the implications for network investment arising from the AER's impending decisions on the WACC parameters.

This submission concludes by setting out the headline justifications for the proposed parameters, particularly where these have changed from currently adopted values.

Current rates of return are not resulting in 'over investment'

The new regulatory framework for determining WACC parameters has been designed to improve regulatory certainty by requiring the AER to have 'persuasive evidence' to support a parameter change. While much of the focus of the review will be on the evidence for each parameter and the persuasiveness of any case for change, it is also useful to reflect on the observed investment outcomes from the current set of parameters, and the conclusions that can be drawn for the current review.

One clear item of contextual evidence for this review is that network investment over the preceding regulatory control periods has not been 'excessive'.

If anything private sector network investment has been consistently *below* regulatory allowances, with the focus being on maintaining network reliability. Were rates of return higher than those commensurate with the underlying financial risks, one would expect to observe significant opportunistic network expenditure as investors sought to earn 'generous' returns. There is no evidence to suggest that this has occurred. Indeed, if anything, the evidence suggests that rates of return may be below those necessary to provide sufficient incentives for network investment.

These general observations should also be considered as part of the evidence to determine whether a WACC parameter should change from its pre-existing adopted value.

Network investment challenges for distributors

The review of WACC parameters is occurring at a time of international financial turmoil, which, when combined with growing network investment demands, gives rise to a demandingly competitive environment for limited investment funds. The AER should therefore be mindful of a need to lay a foundation for ongoing regulatory certainty in its approach to the WACC parameters, and for stability in allowed rates of return so as to ensure that necessary network investment is undertaken.

The gravity of the current financial uncertainty is underlined by the recent bailouts in the United States, as financial markets undergo considerable structural adjustment following the so called 'credit crisis'. Also, the evidence suggests that the corporate bond market is effectively closed to non financial institutions. This has considerable implications for the scope of distributors to finance network investment needs.

In addition to practical concerns as to the availability of financing, and the intense competition for limited funds, the financial risks facing distributors have also increased since the last review of WACC parameters, undertaken by the Australian Energy Market Commission (AEMC) for transmission businesses. These increased risks arise from:

- the restructuring of narrowly based economies, eg in South Australia the economy is in transition from a manufacturing base to one increasingly centred around mining and a growing defence base.
- technological and demand response uncertainty arising from the roll out of advanced metering infrastructure in Victoria over the next five years; and
- uncertainty surrounding the network investment requirements arising from changes in the pattern of use of network infrastructure in light of the carbon pollution reduction scheme and an expanded national renewable energy target.

The combination of a need for new investment, uncertainty surrounding the implications of climate change policies for network investment, and the reduced availability of investment funds mean that the AER should take very seriously persuasive evidence supporting the currently adopted WACC parameters. Indeed, these circumstances are likely to imply that the current set of WACC parameters represent the lower bound of that commensurate with the financial risks facing distributors over the coming period.

Significant network investments will be affected by the review outcomes

The allowance for the cost of capital is critical to network investment decisions, as investors seek returns commensurate with the risks being taken.

The need for significant network investment into the future is being driven by:

- continued and growing demand for electricity, particularly during peak periods;
- rapid aging of the existing network resulting in a need to increase maintenance and replacement expenditure;
- a drive by Federal and some State governments for the installation and operation of advanced metering infrastructure; and
- changes in the pattern of network use arising from anticipated changes in the location of generation units in response to incentives created by climate change policies.

Of particular concern to the businesses over the past few years has been changes to the rate of return at each regulatory reset that have not been the result of changes in fundamental market conditions.

It is for this reason that the businesses support the new WACC parameter review arrangements, but note that the AER's application of these new arrangements will be a critical determinant in their effectiveness at improving regulatory certainty surrounding the WACC.

The key features of the new arrangements are:

- a single national regulator having responsibility for the WACC across each NEM region;
- decoupling consideration of WACC parameters from a regulatory price determination; and
- requiring the AER to have persuasive evidence that a parameter change is warranted before it can be changed.

At this review the AER should be particularly mindful of the implications of its approach to 'persuasive evidence' on investment decisions because of the precedent it sets for subsequent parameter reviews. The AER needs to ensure that it sends the right signals in terms of its support for transparency in its decision making on the WACC parameters, since these principles will be critical for ensuring stability and certainty in the measure and reasoning for allowed rates of return. This will ensure that distributors are well placed to attract the network investment that is required.

Proposed WACC parameters

ETSA Utilities, Powercor and CitiPower each fully support the WACC parameter conclusions that have been reached in the joint association's submission outlined in the table on the following page. Each parameter value is strongly supported by empirical analysis and independent expert reports.

While the WACC parameters that have been used for distribution between Victoria and South Australia have minor variations, it is clear that the policy approach should be to have a single set of parameters across the entire national electricity market.

This means that for equity beta, while South Australia has previously used a value of 0.9, the majority of previous regulatory precedent for distribution has been to use 1.0. For this reason, the businesses support the restoration of an equity beta of 1.0 for all distributors.

The proposed parameters are summarised below:

Proposed weighted average cost of capital parameters

	Previously adopted values for distribution	**Proposed values**
Nominal risk free rate	6.0%	6.0%
Equity beta	1.0	1.0
Market risk premium	6.0%	7.0%
Debt/(Debt + Equity)	60%	60%
Credit rating	BBB+	BBB+
Term to maturity	10 years	10 years
Gamma (netted off tax liability)	0.5	0.2

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Should you have any questions arising from this submission please do not hesitate to contact Lew Owens, CEO ETSA Utilities on (08) 8404 5854 or Shane Breheny, CEO Powercor and CitiPower on (03) 9683 4569.

Yours sincerely

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