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L A W Y E R S

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Subject to final circulation to members

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Dear Members

Request for advice – AER review of the WACC parameters

On behalf of the Energy Networks Association, Grid Australia and the Australian Pipeline Industry Association (the **Joint Industry Associations**) you have requested advice in relation to the AER's review of the WACC parameters.

Under clauses 6.5.4 and 6A.6.2 of the National Electricity Rules (**Rules**), the Australian Energy Regulator (**AER**) is required to review a number of matters relating to various rate of return parameters for electricity distribution and transmission respectively. The outcome of the review is the issuing by the AER of a statement of regulatory intent which adopts values, methodologies and / or credit rating levels for service providers.

The Joint Industry Associations have sought advice from Gilbert + Tobin on the AER's review of the relevant rate of return parameters. In particular, this advice identifies the previously adopted values in the context of the WACC review.

Please find attached our opinion.

Yours sincerely

A handwritten signature in black ink that reads "Nick Taylor".

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OPINION

1 Introduction

Clauses 6.5.4(b) and 6A.6.2(g) of the National Electricity Rules (**Rules**) empower the Australian Energy Regulator (**AER**) to conduct periodic reviews (Reviews) of the rate of return parameters for both distribution and transmission and the first Review is to be completed by 31 March 2009.

This opinion has been prepared for Energy Networks Association, GridAustralia and the Australian Pipeline Industry Association (the Joint Industry Associations).

This opinion identifies the previously adopted values in the context of the WACC review.

2 Parameters and methodologies that will be considered in the review

In undertaking its review, the AER may only review the values of, and the methodologies used to, calculate the following WACC parameters¹:

- the nominal risk free rate;
- the equity beta;
- the market risk premium;
- the maturity period and bond rates²;
- the gearing ratio;
- the credit rating levels; and
- the assumed utilisation of imputation credits (gamma).

3 Previously adopted parameters

It is important to identify the previously adopted parameters for the purposes of the Review because, by clauses 6.5.4(e)(4)(ii) and 6A.6.2(j)(4)(ii), if the parameters cannot be determined with certainty, the Rules specifies a need for there to be persuasive evidence before adopting a parameter that differs from that which has been previously adopted for it.

For the transmission network service providers (that is Chapter 6A of the Rules) the credit rating levels, values and methodologies previously adopted as at the first Review, are those explicitly stated in the Rules. For distribution network service providers (that is Chapter 6 of the Rules), it is not as simple as to identify the previously adopted values because they are not stated in the Chapter itself.

We note that the same provision applies in relation to transmission services as distribution services, and it may be that it was simply replicated without consideration for the fact that the Rules did not adopt a value for the parameters in relation to distribution services. However, in our view, a Court would not conclude that the rule maker inadvertently translated one provision in one context to another, without considering its application in that alternative context. In short, the presumption is that the rule maker intended the words to apply in this new context, unless it is clear that the provision could not apply in that context – as set out below. In our view, the

¹ Clauses 6.5.4(d), 6A.6.2(i) and 6A.6.4, *National Electricity Rules*

² The Rules currently require that the maturity period of bonds to be consistent with the term adopted for the nominal risk free rate. It would appear the AER does not propose to review this link.

provision can be applied in the context of previous jurisdictional determinations and in the absence of inclusion of parameter values in the Rules for distribution services.

In the absence of an express provision that clause 6.5.4(e)(4)(ii) not have a role to play in respect of the AER’s initial formulation of the statement of regulatory intent (which would have been straightforward to achieve from a drafting point of view), then an interpretation that gives these words meaning should be adopted. An interpretation that would give these words meaning is that the AER is required to have regard to pre-existing jurisdictional electricity distribution decisions on WACC parameter values in the March 2009 review. There is nothing in the surrounding legislative context that in our view would support a conclusion that this provision only apply prospectively after the first review.

The Issues Paper identifies a series of statistics for each parameter for gas and electricity distribution businesses and notes that these were “adopted” by jurisdictional regulators. No doubt that information is a useful summary of the history and geography of regulatory decision to assist in stimulating the consultation process. However, for the reasons set out below, we do not consider those statistics can correspond directly to the concept of “previously adopted” parameters for the purposes of the Rules.

One interpretation (Interpretation 1) of the term “that has previously been adopted” is that it is intended only to be a reference to a value adopted in a previous Review or in the Rules. If that were the case, there are, in fact, previously adopted parameters in the Rules for electricity distribution but the only “previously adopted” values for distribution would be the values adopted in the NSW and ACT transitional provisions of the Rules which are in Chapter 11 at 11.15.2:

Table 1

| NSW and the ACT previously adopted electricity parameters | |
|--|--|
| Parameter | Previously adopted figure in the transitional Rules |
| Nominal risk free rate | 10-year CGS |
| Equity beta | 1.0 |
| Market risk premium | 6% |
| Gearing ratio | 60:40 |
| Credit rating levels | BBB+ |
| Assumed utilisation of imputation credits (gamma) | 0.5 |

No other electricity distribution businesses have parameters stated in the Rules and if Interpretation 1 is correct, there would not be any other previously adopted values³.

An alternative reading (Interpretation 2), and one could say the plain reading, would suggest that a “previously adopted” parameter includes, as well as a parameter in the Rules, a parameter found in a pre-existing jurisdictional electricity distribution decision. This is apparently the view expressed in the Issues Paper because in each parameter specific Chapter it refers to a parameter that regulators have chosen to “adopt”.

³ A question then arises (discussed below) as to whether those parameters are “previously adopted” values for all the distribution sector or only for the businesses in NSW and ACT.

However, as noted above, the tables presented in the Issues Paper cannot correspond directly to the concept of a previously adopted parameter in the Rules because:

- The gas statistics must be excluded: In each case, eleven statistics are presented of which five are decisions made not under the National Electricity Rules but under gas legislation. On the plain reading these gas decisions are not ones that have previously adopted National Electricity Rule provisions. We do not consider the electricity Rules can intend the inclusion of the gas decisions because, firstly, the Rules would have said so. Secondly, if the Eastern States gas decisions that the Issues Paper lists should be included on what basis has the Issues Paper stopped there? On what basis would other regulatory decisions not also be included such as the Western Australian gas distribution decision, the Western Australian electricity distribution decision, gas transmission decisions, the Northern Territory decisions, telecommunications decisions, ports decisions, and so on. Such an approach to interpretation would render the Rules most uncertain.
- The NSW and ACT statistics must be excluded: There are two reasons to exclude the NSW and ACT statistics that are listed in the Issues Paper. First, as noted above, the decision is superseded by the parameters more recently adopted in the transitional provisions. Second, the IPART Decision⁴ did not “adopt” values for the MRP, the equity beta, the benchmark or the credit rating and the ICRC did not “adopt” a value for the benchmark credit rating. The common approach of regulators is to identify a range for each parameter and then “adopt” a value within the range. In the NSW and ACT cases identified here the regulator did not take that approach; instead, with NSW adopting a range and the ACT not, the revenue reset decisions was made without identifying a specific point value for the parameter. In the case of NSW, for example, IPART stated that:⁵

To determine what rate of return is appropriate, the Tribunal considers the DNSPs’ and other stakeholders’ submissions on this issue, and calculates a range for the weighted average cost of capital (WACC). It then makes a judgement on what rate of return within this WACC range is appropriate, given the competing objectives in the Code. In particular, it aims to achieve an appropriate balance between the interests of customers and those of the DNSPs.

- The SA electricity distribution beta statistic in the Issues Paper must be excluded: The Issues Paper states that the previously adopted value for this statistic is 0.8 but in fact this was overturned in a review decision and 0.9 substituted. In that context, the 0.9 replaces the 0.8 and the latter has no ongoing legal relevance.

Taking the Issues Paper figures and making those amendments, the relevant individual jurisdictionally specific previously adopted parameters are:

⁴ Independent Pricing And Regulatory Tribunal, *NSW Electricity Distribution Pricing 2004/05 to 2008/09, Final Report*, June 2004, p 60.

⁵ Independent Pricing And Regulatory Tribunal, *NSW Electricity Distribution Pricing 2004/05 to 2008/09, Final Report*, June 2004, p 56.

Table 2

| All jurisdictions electricity distribution parameters | |
|--|---|
| Parameter | Previously adopted <i>individual jurisdictional</i> parameter |
| Nominal risk free rate | 10-year CGS* |
| Equity beta | 1.0 (NSW, Vic, ACT) 0.9 (name states presumably SA, Tas and Qld) |
| Market risk premium | 6% |
| Gearing ratio | 60:40 |
| Credit rating levels | BBB+ |
| Assumed utilisation of imputation credits (gamma) | 0.5 |

* There is a possible divergence in Victoria over whether in that state the statistic is an index-linked instead of nominal statistic. However, it could be said that the parameter is the 10-year CGS and the issue of whether to take a nominal or index-linked 10-year CGS is not a parameter question but a question that is determined elsewhere, in deciding whether to adopt a real or nominal regulatory framework.

The next question is whether the above individual jurisdictional parameters are relevant or whether the previously adopted parameters should be regarded as a single previously adopted value for all of the electricity distribution sector.

4 Jurisdictionally specific previously adopted distribution values or NEM-wide values

The issue of whether for each parameter the Rules speak of a single “previously adopted” parameter for the electricity distribution sector across the NEM or a single jurisdictionally specific parameter is still an important issue because the value of beta is significant and, as a lower order issue, there is also a possible difference in the previously adopted risk free rate.

One way in which clause 6.5.4(e)(4)(ii) could be interpreted is that the reference to a single value can include the plural, in accordance with the general statutory interpretation principle that words in the singular number include the plural and words in the plural number include the singular, unless the contrary intention appears.⁶ In our view, this is not the preferred interpretation, as it would have the effect that the AER must not depart from previous **values** unless there is persuasive evidence. This would imply multiple values in the statement of regulatory intent, potentially different values for each distributor. In our view, a contrary intention appears from the context of the provision, which is more consistent with the AER adopting one value in the statement.

One reason we consider that adopting a single value for each parameter for all of the electricity distribution businesses in this Review is that the purpose of the Review is to streamline the determination of WACC parameters into one five yearly review, avoiding case by case determination of those parameters.

⁶ Clause 1.7.1(b) of the Rules provides that unless the context otherwise requires words importing the singular include the plural and vice versa.

A single figure is also more consistent with other specific provisions in the Rules. Consider that for distribution, the Review is to deliver a statement adopting:

“values, methods and credit rating levels for *Distribution Network Service Providers* or for specified classes of *Distribution Network Service Providers*.”

In our view the language of that provision is only consistent with there being one value adopted in the statement following the Review for all DNSPs or one value per class of DNSPs.

Otherwise, if the draftsman had considered that the terms “values, methods and credit rating levels for DNSPs” could be a series of different values for different DNSPs, the draftsman would not have needed to add the language of “specified classes of DNSPs”.

In our view, a “specified class” should have some reasonable basis for identifying the class and we do not consider, for example, that a class simply identified on the basis that the companies had individual previously adopted values of 0.9 for beta is not a class in the meaning of the above Rules. Any “class” should be established on the basis of criteria that relate to (and justify) different WACC parameters rather than simply on the basis that the business had a particular value for beta adopted in the past.

Although the words “specified classes of DNSPs” was, no doubt, thought to be a worthwhile inclusion for Rules that must be capable of an enduring application, the Issues Paper does not indicate that the AER is conceiving at this stage of there being different classes of DNSP.

What is important about the above observation is that the Rules must operate as a whole. If there is (aside from differences arising between properly defined classes justified by persuasive evidence that particular classes warrant different figures) the single value adopted in the statement must not deviate from previously adopted values unless there is persuasive evidence to do so. If there were a number of previously adopted values (say 0.9 for beta for some businesses and 1.0 for other businesses) and if there were no persuasive evidence that either value should be departed from, there would not be any single value for beta that could be adopted by the AER in its statement. That cannot be the way the Rules are intended to operate.

While it is a textual premise of the section that there is one previously adopted value, the fact that there may not necessarily be one point “value” for the relevant WACC parameters, rather there are several point “values” as different jurisdictional regulators have adopted different values for certain WACC parameters, does not mean that clause 6.5.4(e)(4)(ii) can be simply be ignored on the basis that no *one* value had been adopted.

Although applying the provision where there are different values adopted in different jurisdictions may make the AER’s role more difficult, this of itself is not a reason for interpreting clause 6.5.4(e)(4)(ii) as not requiring the AER to have regard to the transitional provisions for NSW and the ACT and the pre-existing jurisdictional determinations on the relevant WACC parameters in the other jurisdictions.

Clause 6.5.4(e)(4)(ii) could be given effect by the AER having regard to the evidence of previous values and adopting the most commonly chosen value, the average or a mid point. While this sits somewhat uncomfortably with the provision, this interpretation is to be preferred to one that results in the AER simply ignoring previous values because jurisdictional regulators have adopted different values. In our view, it is an appropriate application of the provision to take the most commonly adopted individual value as the “previously adopted” value for distribution.

As can be seen from the data in section 3, the issue of whether a “previously adopted value” under the relevant Rule is a single statistic or whether it should be regarded as a jurisdictionally specific issue is irrelevant except for:

- Beta; and

- Possibly the issue of whether there is a real or index-linked CGS for Victoria.

The latter point is unlikely to cause an issue for the reason identified in the footnote to Section 3 of the table. In any event, it is conceivable that the mere fact of that State being an outlier, combined with the policy decision to harmonise distribution regulation and appoint the AER to conduct the reviews, is itself persuasive evidence to substitute a nominal 10-year CGS for the index-linked CGS.

If a single “commonly chosen” value for beta is to be chosen, “1” is the value that is best identified because:

- “1” has been chosen for the majority of the NEM electricity distribution businesses (ie 8 compared with 4); and
- “1” is also consistent with the electricity transmission sector’s figure.

If, despite our view that the Rules are most consistent with there being a single “previously adopted value”, a Court were to consider that there are DNSP specific or jurisdiction specific “previously adopted” values, the relevant “previously adopted” values would be those presented in Table 2 in Section 3.

5 Conclusion

In our view the values for the parameters that are most consistent with the concept in the Rules of “previously adopted” values is that there be a single electricity transmission and single electricity distribution value for each parameter.

In the case of transmission the values are simply stated in the Rules themselves.

In relation to the distribution parameters and in particular beta, where views may differ, we consider that the best figure, reached on a number of different bases, is “1” and this is superior to the value of “0.9” that has been adopted for a minority of electricity distributors. In our view the each other variable has an unequivocal “previously adopted” value.

In summary, therefore in our view the most appropriate values to regard as the “previously adopted” parameters for electricity distribution are as follows.

Table 3

| Parameter | Previously adopted for transmission | Previously adopted for distribution |
|---|--|--|
| Nominal risk free rate | 10-year CGS | 10-year CGS |
| Equity beta | 1.0 | 1.0 |
| Market risk premium | 6% | 6% |
| Gearing ratio | 60:40 | 60:40 |
| Credit rating levels | BBB+ | BBB+ |
| Assumed utilisation of imputation credits | 0.5 | 0.5 |