Major Energy Users Inc.

AER Review of Parameters

for

Weighted average cost of capital (WACC)

AER Draft Decision

A Submission

from

Major Energy Users Inc

In conjunction with some members of

National Consumers Roundtable on Energy

January 2009

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The views expressed in this document do not necessarily reflect the views of the Consumer Advocacy Panel or the Australian Energy Market Commission.

The content and conclusions reached in this submission are entirely the work of the MEU, noted members of the Roundtable and the consultants.

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Executive Summary

The Major Energy Users and some members of the National Consumers Roundtable on Energy welcome the opportunity to provide comments on the AER Draft Decision on the WACC Parameters.

Consumers – whether they be residential or business and industrial consumers – have been concerned with the high rates of return that regulated network businesses have been awarded or prescribed by regulators and Rule Makers (AEMC) in past years. The AER draft decision has identified that using the current WACC parameters has provided the regulated businesses with a return higher than should apply to businesses with their risk profile. For the AER to accede to the expected network industry's special pleading for even higher rates of return in the light of the global financial situation, will further undermine the interests of consumers, downstream industries, the national economy and employment prospects.

There is a tremendous irony in the special pleading by the regulated businesses for exceptional consideration. At a time when everywhere the trends are for a lowering of interest rates to fend off the worst consequences of a global and domestic recessionary situation, the network businesses are actually seeking a hike in rates. This dichotomy is difficult to reconcile and is illogical. All it does is to make network businesses **even more** profitable then other businesses, distorts the already excessive incentives to invest (note the pro industry Rules on capital expenditures), and further raise network charges at a time when businesses everywhere are seeking to cut costs because of recessionary markets. The ultimate outcome is likely to be further job cuts, more cuts to investments, companies closing down, and network redundancies.

It should be noted, however, that consumers in general do not oppose regulated network businesses receiving fair and reasonable rates of return (consistent with the market as a whole) in order that their businesses and hence, electricity supply (to consumers) can be sustained.

This submission makes the following points in that we:

- Agree with the AER's approach in this review and its decision not to 'mechanistically' derive empirical estimates.
- Agree that the AER should take a 'holistic' approach in its WACC built-up and to also reflect the risk reduction approach applying to the electricity network industry, such as the pro-industry rules applying to proposals for capital expenditures (as part of the AEMC's concept of incentive

regulation), non-optimisation of the regulatory asset base, automatic indexation of assets, etc.

- Note that the AER has deliberately incorporated conservatism into its draft decision, but does not quantify its magnitude. Our analysis suggests that an additional premium of over 20% has been added to the market premium above the risk free rate, based on the use of factors including:

    - Reduced level of gearing
    - Inflated gamma used in the market risk premium
    - Excluding the "Tech Boom" in isolation of the many other exogenous impacts which act to increase the equity beta
    - Adopting lower credit rating, even though two thirds of network businesses are government-owned and have higher credit ratings than privately-owned businesses, as well as including gas network businesses, which have higher weather dependent risks.
    - Treatment of tax imputation available, despite the extent of government ownership of the network businesses.
- Despite special pleading by the network industry that the global financial situation requires a higher WACC than that determined by the AER, this submission draws attention to the fact that the current financial situation actually highlights the (increased) attractiveness of regulated electricity network businesses relative to other businesses, and hence, the unlikely prospect of the former facing funding difficulties. In this regard, we note the attractions regulated industries have over those in competition as the financial situation unfolds:

Competitive market	**Regulated market**
Massive upheaval	Business as usual
Falling sales (volume & cash)	Increased sales (volume and cash)
Major cost cutting, labour shedding	Guaranteed revenue, low elasticity in demand
Capex reduced	Capex increased
Major increases in costs (ETS, MRET, network charges, gas,)	Opex increased
Low share price, low dividend	High WACC, slightly reduced by AER draft decision
Lower profits	Profits guaranteed

- Attention is also drawn to the continued relatively better performance of the utilities sector versus other businesses since the AER draft decision as seen on the ASX and to the favourable recommendations provided by market analysts Ord Minnett and Huntleys for a number of electricity network businesses despite the AER's draft decision.

Overall, the MEU and members of the National Consumers' Roundtable on Energy are prepared to accept the AER's draft decision regarding the magnitudes for the WACC parameters notwithstanding concerns that some parameters are still too much in favour of the network businesses. But consumers will be highly concerned if, as reported to be the market assumption, the AER were to "ease off" between the draft and final decisions, or if the network industry's special pleading concerning the global financial situation were accepted.

1. Introduction

1.1. The Parties to this submission

The Major Energy Users and members of the National Consumers Roundtable on Energy are agreed that on the issue of the Weighted Average Cost of Capital (WACC) parameters review, the large and small consumers of electricity (and gas) have very similar interests.

That the MEU and the Roundtable do have similar interests in this issue is testament to the members of the MEU requiring its views to not only represent the views of large energy users, but also those of smaller power using facilities, and even at the residences used by their workforces.

The National Consumers Roundtable on Energy is a forum established to share information and develop collaborative advocacy strategies to ensure the interests of small end-users of energy (particularly low-income and disadvantaged consumers) are incorporated in the development of policy and regulation of the national energy market. Roundtable participants include consumer organisations, social welfare organisations and environmental organisations, and essentially include all organisations representing small end-users with an interest in national energy regulation and policy. The following members of the National Consumers Roundtable on Energy have specifically advised endorsement of this submission in relation this response to the AER draft decision on the WACC review – Australian Council of Social Services, Consumer Action Law Centre, the Ethnic Communities Council of NSW, Public Interest Advocacy Centre, Consumer Utilities Advocacy Centre, St Vincent de Paul Society, Uniting*Care* Wesley Adelaide and Alternative Technology Association.

Analysis of the electricity usage by the parties involved in this submission shows that in aggregate they consume a significant proportion of the electricity used in the NEM. As such, they are highly dependent on the electricity transport networks to deliver efficiently the electricity so essential to their needs. Large consumers are predominantly exposed to either the transmission or the distribution networks, whereas small consumers are more directly exposed to the distribution networks.

The parties represented in this response have identified that they have an interest in the **cost, reliability, quality and long term sustainability** of the energy networks services as this is an essential element of the electricity and gas supply chains. The respondents recognise that a break in any part of the chain impacts on their goals for energy supply. Electricity is an essential source of energy required by all consumers to maintain their operations (whether

residential or production), and a failure in the supply of electricity (or gas) effectively will cause each consumer significant hardship.

While the key issues for consumers are the **cost, reliability, quality** and the long term **sustainability** of their gas and electricity supplies, the MEU and the Roundtable do recognise the natural tensions between these four competing issues.

1.2 An overview of consumer's assessment of the AER draft decision on WACC.

In its draft decision the AER observes

> "… the AER's approach in reviewing each WACC parameter is to take a balanced approach to the application and interpretation of evidence from market data.
> This may involve:
> - not changing a parameter where the market data is not materially different to the previously adopted value, and
> - not moving as far as the market data would suggest (or not relying solely on the market data) even where the market data is substantially different to the previously adopted value.
>
> In a practical sense, this means that WACC parameters should not be 'mechanistically' derived from empirical estimates. Importantly, this approach will be consistently adopted across the various WACC parameters subject to review. For example, the AER does not intend to mechanistically adopt a point estimate for the equity beta consistent with the recent market data. Likewise, the AER will be cautious in adopting a point estimate for the MRP and, in particular, in interpreting the results from long-term historical estimates when generating a forward-looking MRP estimate.
> ….
> While caution has been exercised with respect to market data, the AER has undertaken a detailed analysis of all the available evidence from submissions and expert consultants, and generated a 'best estimate' or range of estimates for each of the individual WACC parameters subject to review, taking into account conceptual considerations. Consideration is then given to broader issues (e.g. efficient investment incentives, regulatory certainty, etc.) in determining the extent to which these individual estimates for each of the WACC parameters are relied upon in generating the overall rate of return. (AER Draft Decision pages 48 and 49)

We agree that the AER's approach in this WACC review is correct and we consider that the AER has made very significant improvements to the hitherto traditional mechanistic approach in calculating the WACC parameters.

We have, however, identified several key aspects from the draft decision that require comment.

Firstly, any objective assessment of the draft decision would demonstrate that the AER has provided comprehensive analysis to each parameter underpinning the WACC formula. It has examined the issues raised by each submission, consulted with independent academic and market experts, and as well, undertaken significant further analysis of its own, in order to develop its draft decision..

This point was reinforced at the Public Forum in mid December 2008, when the AER Chair (Steve Edwell) observed that the submissions made had been quite comprehensive and detailed and had required the AER having to undertake further analysis in order to reach its current viewpoint.

This comprehensive review by the AER has led the AER chair to make the observation at the public forum, that any changes to its draft decision would have to be based on new information, rather than a regurgitation of previously provided data and information.

It is important for the AER to take such a position. At the earlier forum of experts it was noted that even though each expert debating the issues was extremely well qualified to do so, there was no unanimity. This clearly highlights that there is no one correct answer, and a decision has to be made to balance all the views provided. To re-open further debate on issues that have already been exhaustively debated would not advance the review. The AER has the responsibility to balance competing views and reach a decision based on the information and expert advice provided.

Secondly, in our response to the AER Issues Paper, we submitted that analysis of each individual element of the WACC parameters was difficult in the sense that each separate element could not be readily measured and clearly quantified. It was recognised that each assessment would be open to interpretation and based on different approaches for identifying values could result in a band (or range) of what could be assessed as "correct" answers. As a result, it was recommended that the AER should take an overall holistic view of the outcome of the WACC built-up to assess its overall reasonableness in light of the wider market. Such an assessment would recognise the circumstances applying to the electricity network industry, such as the pro-industry rules applying to proposals for capital expenditures (as part of the AEMC's concept of incentive regulation),

non-optimisations of the regulatory asset base, automatic indexation of assets, and other risk reducing applications unique to the industry.

It is, therefore, more than pleasing to note that the AER draft decision has adopted this approach and, as a result, implemented a carefully developed holistic view of what the single point value for the parameters (allowing for their interaction) should be.

Thirdly, it was recommended in our response to the Issues Paper that there is potential for the AER to take a conservative view for the value of each individual parameter. The risk of doing this is that a compounding conservatism will be built into the final outcome which is much greater than might be intended. This issue was raised at the "Forum of Experts" held in October 2008, and it was the unanimous view of the panel of experts and others at the forum, that it was incorrect to allow this compounding of conservatism to be introduced into the WACC parameters and their outworking. Whilst some of this appears to be addressed within the AER draft decision, it was not wholly embraced, and neither has there been an assessment made of the impact of this conservatism. This matter is developed later in the submission.

Fourthly, an issue that needs to be addressed is that of the global financial situation, which has gathered significant strength over the past few months. This issue was addressed at the public forum held in mid December 2008. A number of presenters at the forum (all representing the views of the regulated businesses) observed that the WACC implicit in the draft decision would, when seen in the context of the global economic conditions, make it exceedingly difficult for the regulated businesses to raise debt funding.

We accept that there is continuing development in regard to the global economic climate, but it must be recognised that most of the WACC parameters either incorporate the impact of previous economic reversals or have a high degree of independence from them. This issue is also addressed in more detail later in the submission.

Fifthly, one major criticism we have regarding the AER assessment of the WACC parameters, is the failure to recognise the wide extent of government ownership of the electricity transport businesses. In particular, this has had a major bias on its evaluation of gamma. By excluding the fact that the bulk of electricity transport is government owned, it has distorted the impact of tax imputation on the sector.

Sixthly, a second criticism is that the AER analysis seems to move far too readily between the electricity transport industry and energy transport as a whole (i.e.

between electricity and gas). The AER makes the very clear statement that the review applies only to electricity transport.

> "The outcome of the AER's WACC review applies only to electricity determinations, and has no direct or formal applicability to gas access arrangements. The determination of the WACC for access arrangements is subject to requirements under the National Gas Law (NGL) and National Gas Rules (NGR), which are not being considered in this review. (AER Draft Decision page 21)

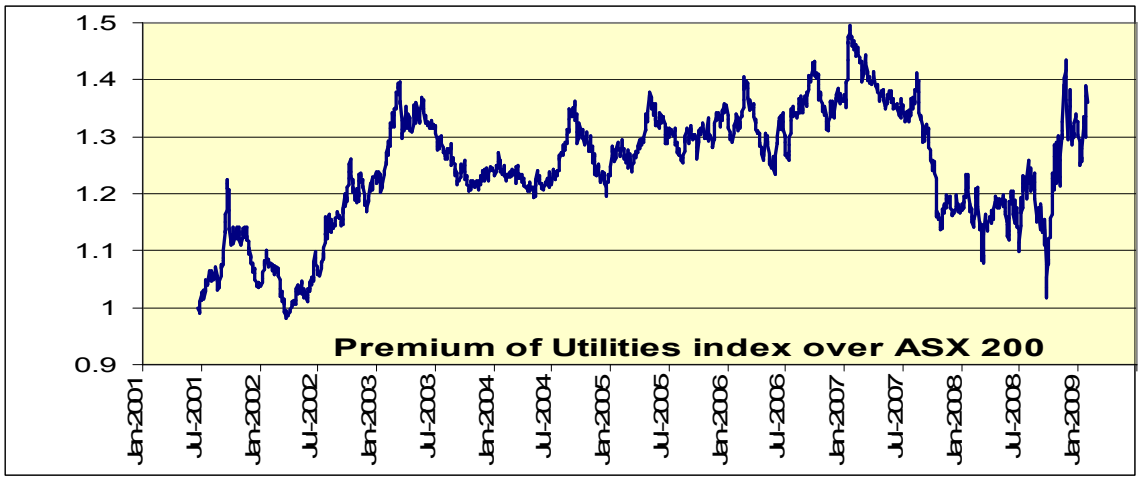
The AER does acknowledge that it may use some of the outworkings of its decision for gas reviews in the future. Notwithstanding this, the AER has biased a number of its assessments (especially credit rating and equity beta) to reflect a gas transportation industry, which has less security of revenue and a higher risk of sales underperforming due to changing weather conditions than does the electricity transport industry, which has a much lower risk of underperforming sales impacted by weather[1].

The AER should note our concerns here and limit its analysis to be reflective of electricity transport only.

1.3 Summary

Consumers expected that the AER would address this review bearing in mind the need for a regulator to manage the regulatory bargain between consumers and network providers in a fair and reasonable way. The market as a whole has considered the Utilities over the long term as more attractive than the market as a whole. This is shown by the continued outperformance of the Utilities index compared to its equivalent general market index.

[1] In this regard electricity sales increase with excessive cold and hot weather, whereas gas sales tend to increase only with excessive cold weather



Source: CommSec, analysis by MEU

To illustrate the reasons for this outperfomance, we provide a table below which lists the comparative benefits and outcomes enjoyed by regulated businesses compared to businesses operating in a competitive market.

Competitive market	**Regulated electricity networks**
Variable revenue	Guaranteed revenue
Sales volatile, heavily dependent on variable demand	Consistently increasing sales, low elasticity in demand
High risk of new competition	Little risk of competition
Capital investment at risk	Capital investments guaranteed
Major increases in costs (ETS, MRET, network charges, power, gas)	Opex consistently increased by regulators. Unforeseen events are usually treated as pass-through costs
Market average dividend lower	Sector dividend higher by ~30%[2]
Market average share price lower	Sector share price higher by ~30%[3]

The above highlights that the outperformance of the regulated energy sector has not been matched by the market as a whole while the financial situation has developed. This is particularly pointed when it is considered the regulated industry has a number of risk minimisation elements provided to it which are unique when compared to competitive industry. Therefore, our submission stated that on a holistic basis the currently used WACC parameters were set too high for the comparative risks faced by regulated firms.

[2] Source: CommSec re Utilities index
[3] Source: CommSec re Utilities index

The AER draft decision sought to rectify this anomaly, although probably not to the extent seen in the outperformance of the sector. In this regard, the AER observes:

> "The AER considers that this rate of return is reflective of a forward looking rate of return for a benchmark efficient service provider that is commensurate with prevailing conditions in the market for funds and the risk involved in providing regulated electricity network services. (AER Draft Decision page vi)

The AER goes on to state:

> "The AER also considers the revised parameters will result in an allowance for the cost of debt that is reflective of the cost of borrowing, at the time of the determination, for comparable debt. (AER Draft Decision page vi)

The parties to this submission recognise that many assessments and assumptions are required to identify point values for the WACC parameters. We consider that the AER has undertaken a difficult task and applied a high degree of analytic and practical sense to develop the outcomes.

Notwithstanding the general support we have for the AER's approach in this review, we note with grave concern some prevailing sentiments typified by the statement made by Ord Minnett in its company review (applying to "…Spark, DUET, SP AusNet and to a much smaller extent BBI.") dated 15 December 2008, in relation to the draft decision, where they state:

> "Historically there has been positive movement [in favour of the regulated business] between the draft and final decisions [of the AER] and we expect a similar outcome from the AER draft."

Should the abovementioned concern be realised, and given that we consider that the AER has still allowed for more conservatism than we consider necessary, then the AER would be increasing the level of conservatism further than should be considered reasonable, and would therefore be reverting to the traditional excessively conservative approach.

This would be a very disappointing outcome of this Review and will accentuate the prevailing distortions and bias towards the network industry which the AER's draft decision clearly demonstrates.

2. Observations regarding the Utilities sector

At the public forum in mid December 2008 representatives of the regulated businesses asserted that the draft decision made by the AER in relation to the WACC parameters would result in returns for the businesses being too low to provide the essential funding needed to maintain the electricity networks adequately to match the needs of consumers. They also noted that the impact of the global credit situation would have a negative impact on funding and that higher costs would be incurred in order to access the required funds.

To a reasonable degree the AER has pre-empted the businesses concerns with regard to the current financial conditions where it states:

> "A number of submissions to the issues paper also highlighted several broader challenges that stakeholders consider must be taken into account when determining the overall rate of return as part of this review. Most notably, submissions from the sector raised concerns about the current state of financial markets, and in particular the current lack of access to corporate debt funding. As part of its review the AER has received advice from finance practitioners regarding the current lack of liquidity in corporate bond markets and the impacts of the 'credit crisis' more generally. Overall, while it is clear that the current conditions in financial (particularly debt) markets are far from favourable, market-based evidence from a number of sources strongly suggests that, rather than creating risks, the regulatory regime insulates energy network businesses from market volatility. Importantly, it is evident that regulated energy network businesses can still gain access to finance in the current market via bank debt, and there appears to be an appetite for investment in regulated energy network businesses." (AER Draft Decision pages iii and iv)

Actions taken to augment debt funding by the Federal government has been massive, fast and consistent as the extent of the financial situation is identified, and these provide significant support for the assessment made by the AER.

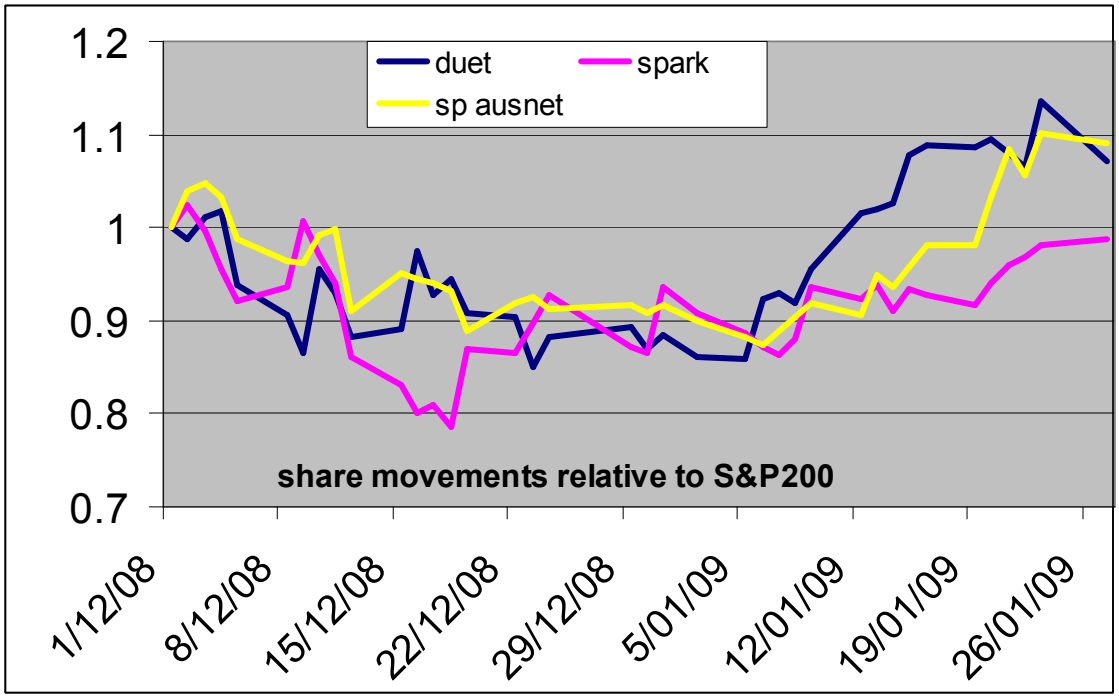
2.1 External assessments of privately owned infrastructure

Already the financial markets have made their views known regarding the AER draft decision. Stockbrokers and financial analysts have already had an opportunity to assess the impacts of the AER decision on the privately owned regulated businesses.

In its analysis of the impact of the AER draft decision, **Ord Minnett**[4] observes that the lower WACC that is implicit in the AER draft decision will reduce the EBITDA for the privately owned electricity distribution businesses of Spark Infrastructure (holding some of Citipower, Powercor and ETSA), DUET (United Energy), and SP AusNet (PowerNet and Eastern Energy). Despite this Ord Minnett still provides a buy or hold rating on these stocks.

Huntley Newsletters (dated 16 December 2008) analyses Spark Infrastructure. It makes the observation that the AER draft decision is "harsh" but then goes on to recommend a "Buy" for the stock. Huntley also reviews the impact on SP AusNet and also recommends a "Buy" for the stock.

A review of the impact of the decision can be seen in the movement of each of these stocks since the AER draft decision and in the movement of the Utilities index, each compared to the ASX S&P 200.

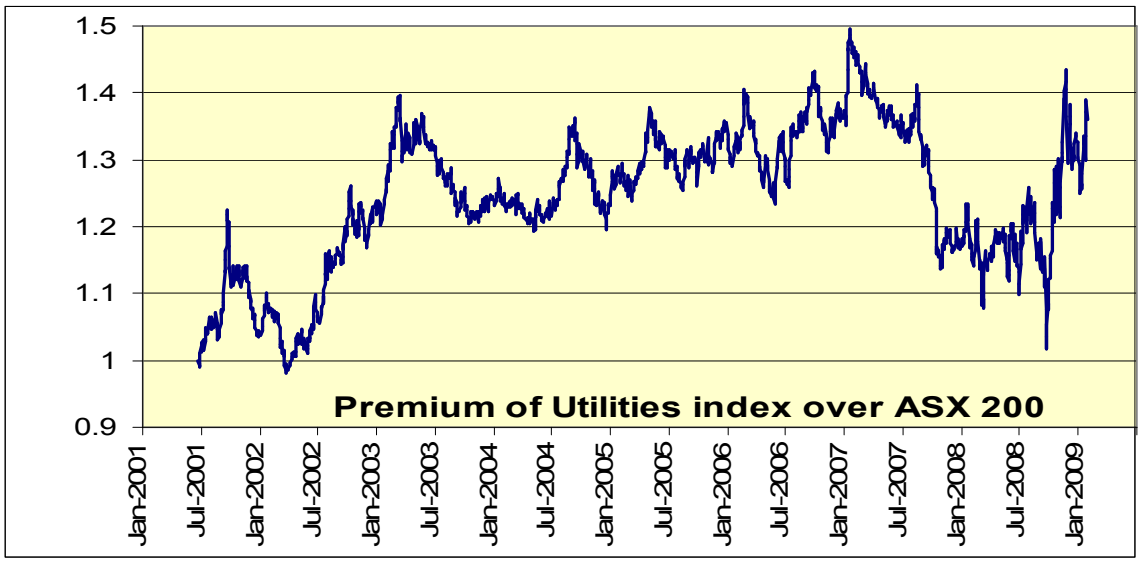


Source: CommSec for data, analysis by MEU

Each of the stocks mentioned by Huntley and Ord Minnett show a distinct and identifiable increase in value from before the AER draft decision and after it, indicating strong market sentiment for the stocks, despite the AER draft decision being referred to as "harsh". Overall this analysis shows that as a whole the market sees the AER draft decision in a positive light.

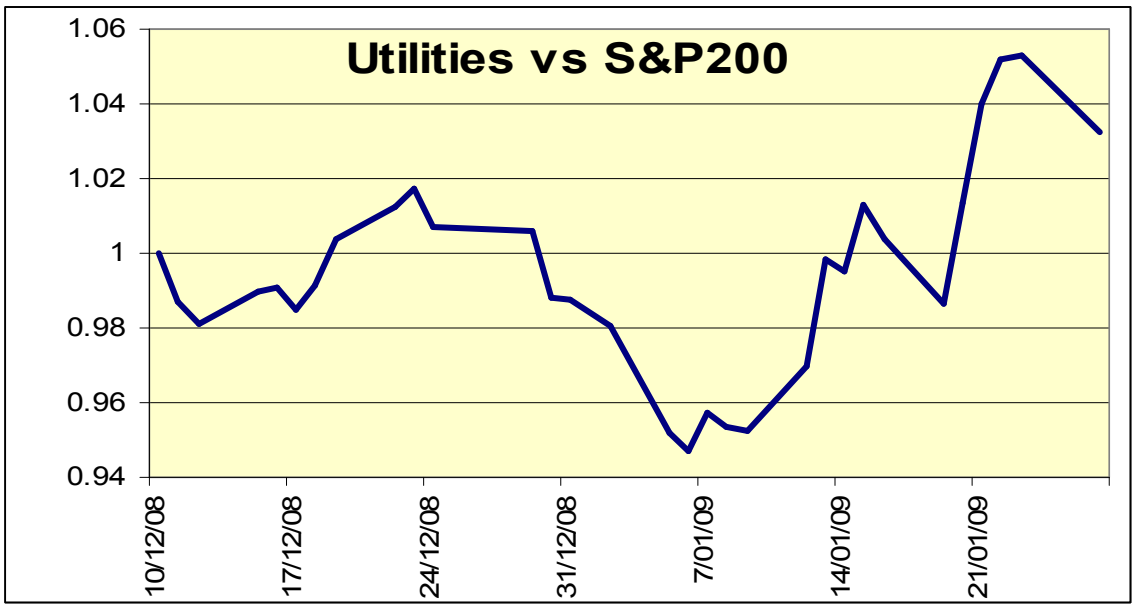
[4] Company Review dated 15 December 2008 – "Valuations hit for 0.8"

In section 1 above we provided a view of the outperformance of the Utilities index (XUJ) compared to its general market equivalent the ASX S&P 200 index (XJO)



Source: CommSec, analysis by MEU

We analysed the comparison for the period immediately prior to the AER draft decision and subsequently in the following graph. This data is a subset of the comparative movement of the two indices since 2001 (shown above).



Source: CommSec

This highlights that, since the AER draft decision the Utilities outperformance has increased, although it has dipped subsequently after rising considerably early in the New Year. This shows that the Utilities are seen by the market since the AER draft decision, as more attractive than the market average.

The above supports the view of the market analysts with their "buy/hold" decisions and confirms that the market accepts the AER draft decision, as Utilities (including the listed regulated electricity networks) are more attractive than other businesses, notwithstanding the global financial situation.

2.2 Summary

There is little doubt that the currently used parameter settings used in the WACC development are individually biased towards the regulated business. Consumers view the AER draft decision as moving in the right direction, and rebalancing some of the bias which regulated businesses have been receiving.

The stock market analysts have made their views known, in that after the AER draft decision was made public and despite criticisms of the draft decision, the listed stocks are rated "Buy" or at worst "Hold".

As late as 23 January 2009, all three stocks were shown with a market depth with more buyers than sellers[5].

Finally, the actual market has shown that it is willing to support the stocks, and movements of the Utilities index relative to the AXS S&P 200 show support for the stocks since the AER draft decision.

Thus the market as a whole, whilst overtly recognising that the AER decision will have a negative impact on their revenues, continues to maintain strong support for the stocks, clearly implying the AER has not been too aggressive in its draft decision, and that these regulated businesses are relatively more attractive than other businesses, notwithstanding the global financial situation.

[5] CommSec website

3. In-built conservatism

One of the major risks that using a formula to develop the WACC to be used in a regulatory reset, is the extent of conservatism that becomes embedded into the final outcome.

Consumers recognise that conservatism in the development of the WACC is preferred to the alternative – a WACC that is too low and as a result, the ability of the regulated firm to provide the services required to meet the requirements of reliability, quality and sustainability, which consumers see as an integral part of the regulatory bargain.

It is also recognised that there is mostly no readily identifiable "point" value for a parameter, and that as most of the parameters are not directly observable, there is a likely range for most parameters. The challenge for the AER has been to identify a likely range for each parameter and than from this generate a point value.

A requirement of the Rules is that in order to make a change from the current parameter settings, the AER is required to identify if there is:

> "… persuasive evidence before adopting a value, method or credit rating level that differs from the value, method or credit rating level that has previously been adopted for it."

Unfortunately, the AER has not defined what it has used as the benchmark for determining "persuasive evidence" in relation to a parameter. It would assist in analysis of the level of conservatism if the AER defined at what point (perhaps in percentage terms) that a parameter should be changed if the market evidence indicates the currently set value is probably in error. To retain a parameter value that is incorrectly set compared to current market data, adds a further level of conservatism in the analysis.

We see that conservatism has three core elements; viz

- That the point value of the parameter is either moved away from its most likely value which would be expected to sit at the median point within the identified range
- That in developing the range of values, a decision has been made to either include or exclude certain inputs in the development of the range
- That the outcome of the development of the WACC from the identified point values includes for a compounding effect, which results in an overall increased level of conservatism that was not intended.

3.1 Inclusion/exclusion of data

The decision to include or exclude certain data does impact on the values used for the parameters. Generally, the AER has provided reasons for its decisions to include/exclude data, and whilst these reasons may be justifiable when considered in isolation, they need to be assessed on a holistic basis. Unfortunately, the AER has not carried out an impact assessment of its decisions on the final outcomes. If the decisions have a bias in one direction, then this affects the degree of conservatism built into the final outcome.

There are five basic parameters that have been assessed by the AER, although a sixth (using the CGS rate based on the term of the reset) was also assessed by the AER. Excluding the term of the CGS, our commentary on each of the variables is as follows:

- **Gearing.** Here the AER made a number of assumptions which effectively reduced the assessment of debt used. Whereas our assessment used all forms of effective debt, the AER reduced the amounts which they considered to be debt and as a result the level of gearing was reduced. The outcome of this decision is to reduce the assessments of the level of gearing identified for the regulated businesses.

- **Market risk premium.**
  In the case of MRP, the AER observed that independent studies had provided some doubt as to the validity and applicability of data prior to the 1950s and as a result placed less emphasis on the data. Using data from 100 years ago, or more, means that it is less relevant to the current financial environment. At the same time, the AER noted that data for the most recent 20 year period was "statistically" insignificant.

  The risk of this approach is that it excludes data which is most relevant to the expected conditions for the near future, as well as excludes data which implies that the value for MRP has fallen in the recent decades. That is the case is to be expected. As the Australian market will tend towards international market values of MRP due to greater international economic and trade exposure, it would be expected that MRP in the different countries would start to converge. The MRP in the UK for instance is assessed at between 3.5-5.0%[6].

[6] Oxera, Assessment of the WACC in the transmission price control review proposals 17 July 2006

The AER also adjusted the MRP for the value of gamma 0.65 that it had developed. This value for gamma assumes that all of the electricity transport businesses are private companies, rather than the vast majority being government owned. Excluding the impact of government ownership effectively reduces gamma. By using a lower value of gamma than actually applies in for electricity transport, inflates the assessed value of MRP.

The outcome of the decisions to use an inflated gamma, include long term data and exclude recent data, all have conspired to bias upwards the final value for MRP.

- **Equity beta.**
  In developing the equity beta, the decision was made to exclude data for the "Tech Boom" as it provided a distinctive bias in reducing the value for equity beta for regulated utilities. To exclude the "Tech Boom" in isolation of the many other exogenous impacts on the equities markets appears to be inappropriate, as other exogenous factors have both increased and decreased the equity beta of firms providing utilities when other market movements (eg crashes of 1987 and 2008, mining boom of 2007) clearly have had an equal if not greater impact on stock markets. Whilst there might some justification for its exclusion, its very exclusion provides a bias in favour of the regulated businesses. In counterpoint to this exclusion, the AER specifically includes the impact of the recent "global financial situation" in the assessments, and this has resulted in the recent increase in equity beta, again providing a bias in favour of the regulated firms.

- **Credit rating.**
  Two thirds of the regulated electricity businesses (on a RAB basis) are government owned firms, and have a high credit rating (many as high as AA+, with all being AA. The privately owned electricity businesses have an average credit rating of A-[7]. Despite the AER observing that it considers the ownership of the firms should not be a criterion for setting the credit rating, the outcome of its assessment effectively excludes the impact of this government ownership.

  The AER goes further, in that it includes the gas transport businesses in its assessment. The impact of the inclusion of the predominantly privately owned gas transport sector is to reduce the overall energy transport sector credit rating, which the AER then uses as its benchmark.

[7] See AER draft decision figure 9.1.

As noted earlier the AER is required to assess the WACC parameters for the electricity sector, and not the energy transport sector. Inclusion of the gas sector introduces an element of higher risk and certainty of the businesses' revenue stream[8]. Therefore, inclusion of the gas transport businesses introduces conservatism into the analysis that should not be present.

- **Gamma.**
  The effect of gamma being less than unity is to increase the pre tax revenue to a regulated business to allow for the inability of certain investors to benefit from the tax imputation available to Australian tax payers. Even though some 2/3^{rds} of the electricity transport business assets are government owned, it is assumed that all electricity transport is owned privately and that the ability of the owners of electricity transport to access imputation credits is the same as the market as a whole. The entire AER approach is based on this assumption. As a result, the decision on gamma is heavily biased towards private ownership of the assets, where in fact the true ownership of the assets implies a heavy leaning towards government ownership. Accepting that the value of gamma assessed by the AER (0.65) is correct, then adjusting this to reflect actual ownership (where 2/3^{rds} is government ownership where gamma would be unity) results in a "weighted gamma" of nearly 0.9.

As can be seen, the AER introduced conservatism in is analysis of each variable by the way it addressed each parameter. Unfortunately as has been seen, there is a clear bias included in the exclusion/inclusion of data for each variable and this bias is consistently in favour of the regulated businesses, increasing the level of conservatism in the final outcome.

3.2 Moving away from the median

- **Gearing.**
  In its final assessment of gearing the AER provides the following summation (page 85):

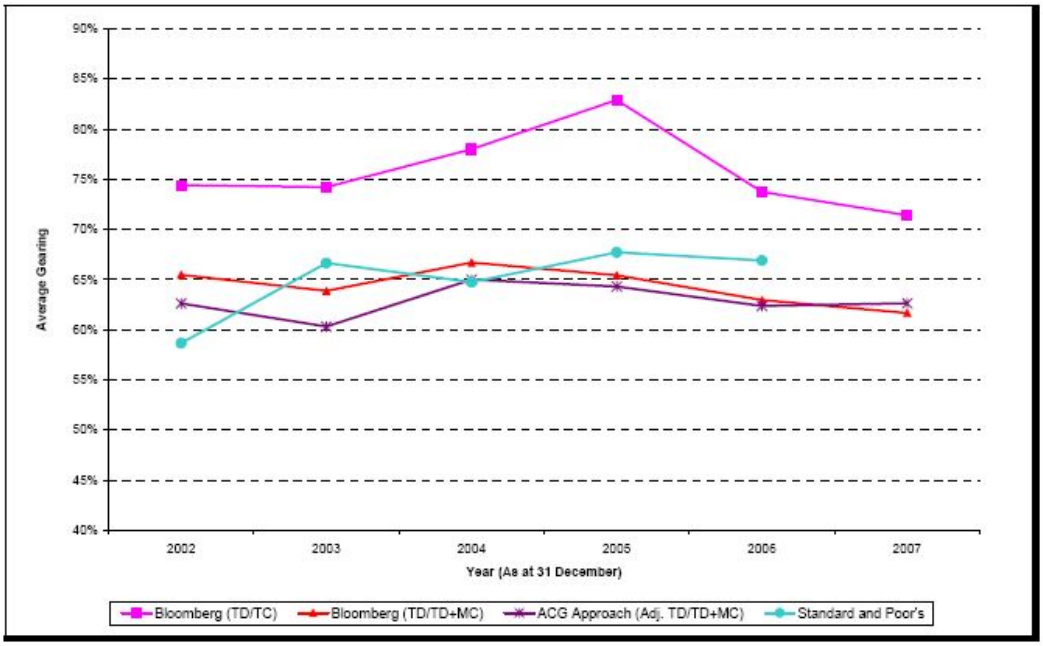
> "In considering a number of different sources and measurements of the gearing ratio the AER observes that:
>
> - The average level of gearing across the four methods of calculating gearing, range from 60.5 to 76.8 per cent over 2002-2006.

[8] Gas businesses are much more susceptible to revenue reductions to due weather than are the electricity businesses

- The generally accepted approach uses the book value of debt as a proxy for the market value of debt and uses the market value of equity (Bloomberg 'market value' approach).
- The ACG's approach adjusts the Bloomberg 'market valuation' approach to gearing for 'double leveraging' and stapled securities. The ACG approach results in an average level of gearing in the range of 60.3 to 65.0 per cent over 2002 to 2007.
- In contrast, the Bloomberg measure of book gearing (i.e. book value of debt and equity) provides a higher average level of gearing. The AER considers that this approach is likely to be an upper bound as no adjustments have been made for market valuations, stapled securities or double leveraging.
- In addition, the Standard and Poor's measure of gearing (book value of debt and book value of equity) provides an average of 64.7 per cent from 2002 to 2006, which supports the conclusion that a 60 per cent gearing is an appropriate benchmark.

That all of these assessments result in a higher level of gearing than 60% appears to be ignored by the AER, as it finally decides that there is no persuasive evidence to change from the level of 60%. The results are graphically summarized in AER figure 5.1

Figure 5.1: Comparison of different approaches



A reasonable assessment of the AER deliberations is that on average, gearing is likely to be ~65%. This is some 10% higher in relative terms than the level the AER settles on. The question then arises: does a 10% variation provide "persuasive evidence"? We consider that 10% is significant and the AER is in error in discounting the observed gearing to 60%.

- **Market risk premium.**
  To a degree the assessment of MRP is partly impacted by the decision of the AER to use a CGS bond rate for the risk free rate (RFR) reflecting the term of the regulatory period used, and of the value used for gamma.

  We agree that the RFR used should reflect the term of the regulatory period, and as a result there is a need to make some adjustment in the MRP to reflect the impact of this decision. The AER identifies that the differential between the long term CGS for 5 and 10 year periods is a relatively modest 20 basis points.

  The AER uses a value for gamma of 0.65 to develop a long term value for MRP, whereas a value of 0.9 reflects the actual ownership structure of electricity transport.

  Adjusting for these the AER provides a summary of its view of MRP:

Table 7.7: Measures used to estimate the market risk premium

Measure	Support MRP
Historical estimates {grossed-up for imputation credits, relative to a 5 year risk free rate)	6.1 to 6.7 per cent
Surveys	Consistently 6 per cent
Cash flow based measures	Around or lower than 6 per cent

It concludes that MRP of 6% should apply based on its view there is no persuasive evidence to vary the value currently used. However, if recent data and a higher value of gamma were used, then there becomes an argument that MRP should be reduced below 6%.

On balance we would assess that MRP currently lies between 5.5% and 6% but with the increased globalization of the financial and stock markets, we see that in the medium term MRP will fall well below the currently used 6%. This provides some justification for the AER to reduce MRP but on

balance it is agreed that there is probably insufficient market based evidence to justify a move form the currently accepted value of 6%.

- **Equity beta.**
  The AER has decided that it will specifically exclude data applying during the "Tech Bubble" but include all other data that might equally be impacted by exogenous events. This has the impact of increasing the values of the equity beta for electricity transport. Such exogenous factors would include the massive element of trading in electricity transport assets as Alinta acquired and then divested its portfolio of energy transport assets, and the more recent massive share value losses incurred as a result of the global financial failure. Both of these recent exogenous factors would have increased the equity beta of the sector. Exclusion of the "Tech bubble" and inclusion of recent data has resulted in an increase of the observed equity beta values of Australian electricity transport businesses.

  The AER notes (draft decision page 252)

  > - The empirical evidence considered by the AER suggests that the equity beta of a benchmark efficient service provider is in the range of 0.44 (average portfolio estimated by the AER for Australian businesses post 'technology bubble') to 0.68 (average portfolio estimated by the ACG for the JIA using a five-year estimation period).

  It then goes on to point out it intends to inflate (make more conservative) its detailed assessment for a number of reasons

  > - In considering the empirical evidence, the AER's approach to reviewing the equity beta is to take a balanced approach to the application and interpretation of market data by having regard to the strengths and weaknesses of the market data available. In a practical sense this means that the AER does not propose to change the equity beta value as far as the market data would suggest, even though the market data suggests the value is substantially different to the previously adopted value(s). In reviewing the equity beta, as for the other parameters, the AER has given consideration to other factors, such as the importance of regulatory stability, in order to promote efficient investment, so as to contribute to the National Electricity Objective. Consequently, whilst the market data in isolation presents a strong case for establishing an equity beta at a point consistent with above range, the AER has taken a broader

> view in the context of the National Electricity Objective and having regard to the current financial environment.

The effect of its conservatism is quite influential. The data suggests the point value for equity beta lies within the range of the AER assessment (at 0.44) and that of the JIA consultants– ACG – as adjusted by the AER (at 0.68). The AER then determines a figure above the adjusted ACG value of 0.8 is the optimum level.

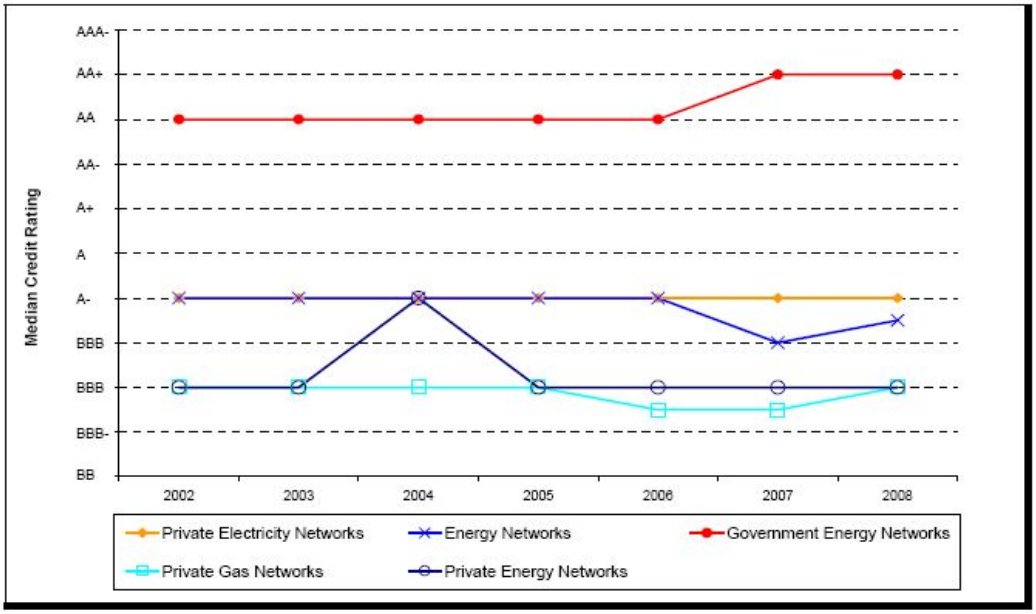
If the AER followed its practice elsewhere in the draft decision it would have opted for a point value in the middle of the range, ie a value of 0.56.

The impact of the AER decision is to build a conservatism of some 40% into the valuation of the equity beta.

- **Credit risk.**
  The AER provides analysis of its assessments of the credit risks applying to all energy (gas and electricity) transport businesses.

  In its assessment it graphically represents the three main sectors – government owned electricity transport, privately owned electricity transport, and gas transport (which is predominantly privately owned). This graphical representation is shown on page 285 of the draft decision.

Figure 9.2: Annual median credit rating (2002 - 2008) – Number of businesses[713]



What this highlights is our main aspect of concern – that government owned electricity transport has a credit rating of AA/AA+ and the privately owned electricity businesses have a credit rating of A-. It is the presence of the gas transport businesses that reduces the overall average assessed by the AER to a level of A-.

If the gas businesses are excluded then it becomes an issue of where between the A- level applicable to privately owned businesses and the AA+ level applicable to the government owned businesses. As government owned businesses comprise some 2/3^{rds} of the assets used for electricity transport, then a weighted credit rating of between A- and AA- should apply.

Our submission to the Issues Paper recommended a credit level of A+ and this level is supported by the analysis of the AER when assessing purely electricity transport, as this review is required to do.

- **Gamma.**
  The AER views that gamma should be changed from the historically based assessment of 0.5 (Draft Decision page 338)

> "Based on the evidence considered most relevant, reliable, comprehensive and theoretically appropriate, the AER considers that a reasonable estimate gamma lies in the range 0.57 and 0.74."

To reach this the AER assessed (Draft Decision page 339)

- "A payout ratio of one has been adopted, consistent with a free cash flow approach to valuation and the Officer WACC framework,
- The lower bound estimate of 0.57 is based on the AER's best estimate of theta inferred from market prices, and
- The upper bound estimate of 0.74 is based upon the AER's best estimate of theta from tax statistics."

What the AER fails to do is to include the impact of the government ownership of the electricity transport businesses. Effectively these would have a gamma of 1.0. When the effect of this is introduced on an average basis, a gamma of 0.88 would eventuate, based on 2/3^{rds} of the electricity transport sector being government owned.

3.3 Compounding conservatism

When a regulator takes a conservative view of every element that goes into the building block, then there is the risk that the final aggregated level of conservatism is grossly overstated.

For example, the development of the WACC contains a number of estimated inputs – market risk premium, equity beta, gearing and gamma.

If a 10% bias is added to each of the variable inputs, then the impact on the final level of nominal WACC has a conservatism approaching 10% as shown in the following table. In this table, the parameters are those used as required in Chapter 6A of the National Electricity Rules.

Parameters	% debt	DRP	βe	MRP	% equity	RFR	Nominal WACC
Chapter 6A	60%	2%	1	6%	40%	6%	9.6%
Chapter 6A + 10%	54%	2.2%	1.1	6.6%	46%	6%	10.5%
Chapter 6A - 10%	66%	1.8%	0.9	5.5%	34%	6%	8.8%
MEU	70%	1.5%	0.7	5.5%	30%	6%	8.2%

What this table shows is that allowing a level of conservatism in every element of the WACC development results in large movements in the nominal WACC premium above the risk free rate – in fact a 10% premium in each of the WACC parameters increases the WACC premium above the risk free rate by some 25%! The compounding effect of "conservatism" in the WACC parameters provides a massive proportionate increase in the WACC premium above the risk free rate.

If the impact of "gamma" (the value to shareholders' share of tax imputation credits) is further added at "a conservative" level currently assessed as 0.5[9], then the conservatism in the WACC is further enhanced.

In our earlier submission, we recommended that the AER must recognise the risk of compounding conservatism in its assessments and development of the WACC parameters. This point was raised at the forum of experts and all of them confirmed that compounding of conservatism should be avoided.

The clear import of this strong recommendation from all the experts (those supporting the businesses, those supporting consumers and the AER independent expert) was that the risk of compounding conservatism provides an unknown level of conservatism in the final WACC used.

[9] There are economics experts that consider gamma is higher than 0.8, and should be set at 1.0!

To overcome this risk, the AER should have assessed the optimum point value based on the range it developed. Following this it should then have added a defined element of conservatism, probably by deliberately changing one parameter to carry all of the conservatism required.

3.4 Tabulation of the degree of conservatism inherent in the draft decision

Based on the analysis in sections 3.1 and 3.2 above, the degree of conservatism in the draft decision can be tabulated. The following table lists the historic WACC parameter values, AER draft decision values and the values implied by the AER draft decision but removing the conservatism

Parameter	Historic	AER Draft Decision	AER without conservatism
Gearing	60%	60%	65%
MRP	6%	6%	6%
Equity beta	0.9-1.0	0.8	0.56
Credit rating	BBB+	A-	A+
Gamma	0.5	0.65	0.88

From the market based data, the AER has effectively changed from the market based value points, by:

- Reducing the gearing
- Reducing the credit rating
- Increasing the equity beta, and
- Reducing the gamma

All to these decisions are to increase the revenue to the businesses, and are therefore considered to be conservative.

The effect of reducing the gearing has only a minor impact on the vanilla WACC by increasing it by ~7 basis points

The effect of reducing the credit rating has the minor impact of reducing the vanilla WACC by ~10 basis points.

By far the greatest impact is changing the equity beta which has been increased from 0.56 to 0.8. The degree of conservatism of this decision by the AER has been to increase the vanilla WACC by some 35 basis points.

The effect of reducing gamma from 0.88 to 0.65 will significantly increase the revenue to the regulated business

In aggregate, the degree of conservatism on the nominal vanilla WACC is ~50 basis points, being the sum of the values for gearing, credit rating and equity beta.

However, when all of these errors are introduced into the WACC formula the change is some 70 basis points – 20 basis points more than the aggregate of the individual degrees of conservatism. Thus the compounding effect of the conservatism has increased the effect of the individual conservative elements by increasing the degree of conservatism by 40%.

When seen in context, the conservatism built into the AER draft decision is some 70 basis points or some 20% higher than the premium above the RFR than it need be.

3.5 Conclusions

The AER has deliberately incorporated conservatism into its draft decision. The impact of this conservatism is un-quantified by the AER but our analysis indicates that it is an additional premium for conservatism of over 20% added to the market premium above the risk free rate applicable to electricity transport utilities.

We agree that there should be some conservatism built into the rate, but we consider that the amount of conservatism, after allowing for the compounding effect, is likely too high.

We consider that the AER should develop its parameters as close to the values the market considers is appropriate and then add a separate identifiable premium to the outcome. From this, it can back track to set a single parameter deliberately high to achieve the desired outcome.

In principle, we consider that a 10% of the premium above the risk free rate is more than adequate to provide the necessary conservatism in the final assessed values of the WACC parameters.

4. Global financial situation

At the public forum in mid December 2008, the representatives of the regulated businesses asserted that "the sky will fall" as a result of the AER draft decision. In particular, they noted that financial institutions would not lend at the rates implied by the draft decision, and that as a result investment in essential electricity infrastructure would fall dramatically.

In our presentation to the public forum in December we provided the following table which highlights the lower risks faced by electricity transport businesses, especially in times of financial and economic weakness such as apply now:

Competitive market	**Regulated market**
Massive upheaval	Business as usual
Falling sales (volume and cash)	Increased sales (volume and cash)
Major cost cutting, labour shedding	Guaranteed revenue, low elasticity in demand
Capex reduced	Capex increased
Major increases in costs (ETS, MRET, network charges, gas,)	Opex increased
Low share price, low dividend	High WACC slightly reduced
Lower profits	Profits guaranteed

Against the above relative comparisons, we posed the questions:

- Where would you invest?
- Banks have the funds – why are they wary of where they invest?

A key aspect of the current financial imbroglio concerns lenders' concerns with the value of assets of customers and the revenue stream available to provide certainty of the debt repayments being made. As a result credit rationing occurs as lenders become cautious with the ability to repay.

Regulated utilities do not have the same problems as businesses operating in a competitive market as they are safe businesses whose assets are safely indexed upwards by regulators and whose regulated revenues are determined to service those guaranteed assets (values) and as a result costs and profits are guaranteed.

So the issue here is NOT about the cost of funds and there is no requirement that higher WACCs must be provided to the utilities to allow them to raise funds from lenders. In fact, the current financially driven recessionary situation and outlook reinforces a unique aspect of regulated utilities. Whilst every other company or industry in the competitive market can suffer profit reductions or even losses, these utilities actually have their profits AND costs set by the regulators and therefore become underwritten by consumers with no ability to seek lower costs and who have historically exhibited a very low elasticity of demand, which even increases in poor economic times. Even as consumption declines in many areas of consumer demand as the economic conditions bite, electricity demand does not follow this pattern. Many of the regulated electricity transport businesses even have their profits and revenues effectively immune to consumption changes as they operate under a revenue cap where revenues per unit are raised as consumption falls.

Lenders are familiar with the safety of such entities. At a time when all over the market place risks are rising for firms in the competitive market, utilities will be seen as good customers by lenders, and therefore do not require special treatment or compensation by way of a higher regulated WACC.

4.1 Availability of debt

In the current environment the issue becomes one of "how bankable is the borrower" in this new world of increased financial risk. One of the key aspects that lenders will concentrate on will be the degree of transparency of the financial aspects of businesses. In the case of regulated businesses the processes used to set their revenue streams are very transparent, enhancing the relative ease by which they will address financing and refinancing the debt they need.

Such unique features make them very attractive to lenders in a credit constrained world.

It would appear that this was in mind when the AER observed that:

> "A number of submissions to the issues paper also highlighted several broader challenges that stakeholders consider must be taken into account when determining the overall rate of return as part of this review. Most notably, submissions from the sector raised concerns about the current state of financial markets, and in particular the current lack of access to corporate debt funding. As part of its review the AER has received advice from finance practitioners regarding the current lack of liquidity in corporate bond markets and the impacts of the 'credit situation' more generally. Overall, while it is clear that the current conditions in financial (particularly debt) markets are far from favourable, market-

based evidence from a number of sources strongly suggests that, rather than creating risks, the regulatory regime insulates energy network businesses from market volatility. Importantly, it is evident that regulated energy network businesses can still gain access to finance in the current market via bank debt, and there appears to be an appetite for investment in regulated energy network businesses." (AER Draft Decision pages iii and iv)

That this is the case is echoed by Fitch Ratings who, in February 2008, observed that Utilities are "a safe haven":

> "While Fitch has no expectation of a significant slowdown in the Australian economy, the cash flows of utilities businesses are anyway relatively insensitive to the economic cycle:
>
> - electricity and gas have relatively price inelastic demand; and
> - although lower economic growth generally leads to lower demand for electricity and gas, this rarely has a very material impact on the financial performance of utilities
>
> As such, many investors view utilities as a safe haven in times of credit concerns or economic slowdown. For example, In the Fitch report *U.S. Utilities, Power and Gas 2008 Outlook*, the agency takes a stable to positive outlook across the sector in the short term, with a negative flavour creeping in over the longer term."

That Fitch makes these comments before the credit crunch occurred is indicative of the long term view on Utilities.

That debt will be available has been the focus of a number of statements from the Federal Government over recent days. The best summation of the government determination to ensure debt funding will be available is provided in a report in the Australian Financial Review 23-26 January 2009:

> "'Rudd Bank' ready if foreigners withdraw
> The Federal government and major banks will pour up to $5 billion into a special-purpose vehicle to ensure companies retail access to credit if foreign companies pull out of Australia.
> The government will provide half the funds for what is being referred to in banking circles as the "Rudd Bank", with the rest to come from the Big Four banks. The money will be used to cover any shortfall in syndicated loans resulting from troubled foreign banks pulling out of the Australian market to repatriate capital. …

> Prime Minister Kevin Rudd on Thursday said the government was prepared to do "whatever is necessary" to ensure credit remained available to Australian business."

4.2 Will the credit crunch impact WACC parameters?

It is alleged that the financial situation has led to a step change in financial markets, necessitating a step and long term increase in the WACC parameters. Consumers do not agree, and concur with the AER in its assessment of the impact of a change in the WACC parameters in light of recent financial market movements. The AER observes:

> "It is also important to note that, for the majority of electricity network service providers (NSPs), the outcomes of this review will not apply until after 2011, and the last year in which the outcomes will apply will be 2019. Accordingly, while cognizant of the current volatility in financial markets, the AER considers it important to take a long term perspective in setting rates of return applicable over the 2010 to 2019 period." (AER draft decision pages iii and iv)

When reviewing each individual parameter, this sentiment is further amplified by a detailed assessment of the origins of each parameter. The gearing, long term MRP and gamma should not be affected by a change in the financial conditions. as:-

- **Gearing** is a decision of the business and how it structures its financial model. The AER has assessed gearing on the basis of how the businesses themselves have financially structured their businesses. Should there be a step change, this will be evidenced for the AER next review in five years time. To pre-empt a change in gearing would entail making assumptions that have no basis in reality.

- **Market risk premium** is based on a long term view. The AER has assessed data extending beyond 100 years and the main decision is based on data applying for over 50 years. Within these periods the market has seen "boom and bust" a number of times, including periods of tight and freer credit. To assume that the current financial situation is unique and it alone has resulted in a step change is again attempting to foresee the future on no credible basis

- The need for including **Gamma** in the WACC calculation is a relatively recent innovation. There is only short term data available and even so, the data includes for significant market gyrations and therefore has some longitudinal basis for the AER to make a balanced assessment. Again to

pre-empt that the current situation will result in a step change is purely based on perception and no hard data. For the AER to make changes based on perception is not permitted by the Rules.

It is accepted that both equity beta and debt risk premium are impacted by short term influences. However it should be noted that credit rating is not so impacted and it is the credit rating that the AER is setting, not debt risk premium which is an outworking of the credit rating.

- **Credit rating** is a qualitative assessment and is a ranking rather than a fixed value. Although over time as the financial implications will impact the quantum of the debt risk premium the positioning of businesses will remain relatively stable. If anything, the credit worthiness of stable revenue secure businesses will be see enhancement in times of financial distress, when compared to businesses with a more volatile revenue stream. What will occur is that the cost of debt (the debt risk premium) could increase overall, although the Federal government is endeavoring to minimise this impact.

  The amount of debt risk premium (DRP) that results from a credit rating level is relative to the market circumstances at the time. For example, with scarce debt available the debt premium for the same credit rating would be higher than when debt was readily available. This can be readily shown by the housing market. As debt became scarcer as the financial situation worsened, the banks increased their premium above the cash rate. When debt was readily available, the banks set the premium above the cash rate to a lower level.

  This means that there is implicit recognition in that the WACC will be higher when debt (such as in the current financial situation) is scarcer. Over time the DRP has changed between regulatory resets for the same credit rating, and current levels of DRP are higher than when credit was easily available.

  To change the credit rating in order to recognise the current availability is neither necessary nor appropriate.

- On average, as a result of the current financial situation, **equity beta** appears to have approached unity for all sectors, with those with equity betas less than 1 moving towards the market average of 1 and those above 1 also moving towards the average, indicating a market which is unsure of where to buy and sell. If this exogenous event is to receive special consideration then it would be equally applicable for other exogenous events to be treated in a like manner. The decision by

regulators to eliminate the impact of the “Tech Boom” from assessments of the equity betas was based on the premise that inclusion would bias the outcomes, and that it was clear that this was necessary based on the subsequent data that became available. Currently there is little data available on which the AER could make an assessment that the equity beta for Utilities has undergone a step change, as distinct form the observed normal movements seen on a regular basis. It will be sometime in the future before it might be seen that the current financial situation has created a step change. At the next review in five years the AER some data on which to assess whether there has been a step change, whether to exclude the impact (as it has for the “Tech boom”) as a once off event or to consider the movement as part of the market operating in its normal fashion.

Overall, the WACC parameters are relatively independent of the financial markets and its gyrations, or require more actual data on which to base an informed decision, as distinct from a speculative pre-emptive assessment.

4.3 Has the AER Draft Decision impacted the Utilities market?

Most electricity transport businesses are government owned and, as such, are effectively immune from the market deliberations and assessments. As a result to infer any impact is purely speculative and cannot be supported by any independent assessment. This means that the AER must rely predominantly on market data resulting from the publicly listed owned electricity transport businesses.

As noted in section 2 above, the market has already decided that the listed regulated electricity utilities have not had their supportive market sentiment adversely affected, and the actual trend of share acquisitions has if anything been enhanced since the AER released its draft decision

4.4 Conclusions

Overall, it is not considered by the market, that the change to the WACC parameters has had a significant influence on the market sentiment for electricity transport businesses.

When analysis is carried out of the origins of the WACC parameters and these are assessed, it is not clear (other than perhaps for equity beta) how the relativity or values of the WACC parameters would have changed as a result of the recent financial market gyrations.

It is not expected that the global financial situation will continue for the entire period over which these new WACC parameters will apply, and so analysis of them must reflect the long term application of them, in that they will apply after the global financial situation is considered to be over.

We therefore concur with the assessment of the AER that the impact of the current financial conditions should not be a reason to vary the relativities or point values.

5. Conclusions

Overall, the analysis undertaken by the AER in its draft decision demonstrates a good understanding of the issues. It has been noted that regulated firms have devoted considerable effort and cost to provide regulators with reasons why there should be increases in each of the areas associated with the financial side of the regulatory review.

Our submission to the Issues Paper implied that on a holistic basis the currently used WACC parameters were set too high for the comparative risks faced by regulated firms. The AER draft decision rectifies this anomaly, although probably not to the extent implied by the outperformance of the sector. In this regard, the AER observes:

> "The AER considers that this rate of return is reflective of a forward looking rate of return for a benchmark efficient service provider that is commensurate with prevailing conditions in the market for funds and the risk involved in providing regulated electricity network services. (AER draft decision page vi)

The AER goes on to state:

> "The AER also considers the revised parameters will result in an allowance for the cost of debt that is reflective of the cost of borrowing, at the time of the determination, for comparable debt. (AER draft decision page vi)

The parties to this submission recognise that many assessments and assumptions are required to identify point values for the WACC parameters. We consider that the AER has undertaken a difficult task and applied a high degree of analytic and common sense to develop the outcomes it has. The outcome is one that consumers can accept, recognising there still remains a high degree of conservatism within the outcome.

The risk for consumers in overtly supporting the draft decision by the AER is typified by the statement made by Ord Minnett in its company review (applying to "…Spark, DUET, SP AusNet and to a much smaller extent BBI.") dated 15 December 2008 in relation to the AER Draft Decision where they state:

> "Historically there has been positive movement [in favour of the regulated business] between the draft and final decisions [of the AER] and we expect a similar outcome from the AER draft."

If the AER is moved to change the parameters from its draft decision, then the parties to this submission would expect that any reassessments will include

greater recognition of the degree of conservatism that has been built into the final outcome, including assessment of the data included/excluded, and the setting of the point data within the range of outcomes that have been developed.