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

24 September 2008

Dear Chris,

Submission on AER's Issues Paper: Review of the weighted average cost of capital (WACC) parameters for electricity transmission and distribution

SP AusNet welcomes the opportunity to provide this submission in response to the Issues Paper published by the AER on its review of the WACC parameters for electricity transmission and distribution.

As the owner of the Victorian electricity transmission network and one of five electricity distribution businesses in Victoria, SP AusNet regards the AER's review as being of critical importance to the company, and to all users of the company's network services in Victoria.

SP AusNet is an active member of the Energy Networks Association and Grid Australia. Together these industry associations, along with the Australian Pipeline Industry Association (the "Joint Industry Associations") have lodged detailed and comprehensive submissions to the AER. A substantial amount of expert advice was obtained by the Joint Industry Associations in the course of preparing their submissions. SP AusNet strongly supports the conclusions of those submissions.

This submission sets out SP AusNet's overarching views on the critical importance of the regulatory WACC in providing incentives for efficient investment in the face of recent developments in global capital markets, and the ongoing investment requirements of the electricity network sector in the face of climate change. The attachment to this letter provides a summary of the WACC parameters advocated by SP AusNet, based on the detailed submissions lodged by the Joint Industry Associations.

Within a regulatory framework such as the one established by the National Electricity Rules, the WACC is typically the single most important element of the "building block" formulation that is used to derive the regulator's estimate of a regulated utility's total revenue requirement. Within this framework, the incentives for providers of capital to continue to invest in regulated infrastructure are profoundly influenced by regulators' views and decisions on the WACC. Regulatory decisions on the WACC therefore have significant impacts on:

CERTIFIED QUALITY MANAGEMENT SYSTEM ISO 9001
CERTIFIED SAFETY MANAGEMENT SYSTEM AS/NZS 4801
CERTIFIED ENVIRONMENTAL MANAGEMENT SYSTEM ISO 14001

- prices paid by consumers;
- returns earned by infrastructure owners; and
- the incentives for on-going investment in regulated infrastructure.

There is a significant degree of imprecision and subjectivity involved in the estimation of the cost of capital, and there is certainly no one objectively determinable "correct" estimate of the WACC or the constituent WACC parameters that are the subject of the AER's review. It is universally recognised however, that there are very large potential costs to society as a whole that arise from the risk of regulators setting WACC at a level that is insufficient to encourage on-going investment in infrastructure over the long term.

The AER is no doubt aware of the findings of the Productivity Commission's reviews of the National Access Regime[1] and the Gas Access Regime[2], which identified the difficulties in estimating WACC in a regulatory context, and which highlighted the potential for regulators' decisions on WACC to result in disincentives to efficient investment.

Following the conclusion of the Productivity Commission's reviews, the MCE established the Expert Panel on Energy Access Pricing, to advise on a model for achieving a common approach to network pricing across the national energy market. The Expert Panel delivered its final report in April 2006, in which it reiterated the need for regulatory decision-making to provide appropriate and effective incentives for investment, as follows[3]:

> "A regulatory environment that is conducive to desirable investments being made in a timely way is important. This means not only appropriate returns in the short term but that potential investors can be confident that sound substantial long term investment decisions can be based on a well understood and predictable regulatory regime and not rendered loss-making by subsequent regulatory intervention.
>
> Equally important is the predictability of those decisions – that is the development of an approach that gives energy users and investors in transmission and distribution infrastructure confidence that access and pricing outcomes will be guided by known principles that are applied in a consistent manner."

In particular, the Expert Panel noted[4]:

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1 Productivity Commission, *Inquiry Report No. 17, Review of the National Access Regime*, 28 September 2001.

2 Productivity Commission, *Inquiry Report No. 31, Review of the Gas Access Regime*, 11 June 2004.

3 Expert Panel on Energy Access Pricing, *Report to the Ministerial Council on Energy*, April 2006, page 59.

4 Expert Panel, *Energy Access Pricing: Report to the Ministerial Council on Energy*, April 2006, page 11.

“… the need to ensure that the [regulatory] regime continues to provide the incentive and capacity for owners of energy networks to continue to undertake timely and efficient infrastructure investments.”

In this vein, it is noteworthy that the economic regulator in New Zealand (the Commerce Commission) has explicitly recognised the potential for damage to investment incentives to arise from regulatory decision making on the WACC, as follows[5]:

“The Commission notes concerns about the asymmetric nature of errors in assessing WACC, i.e., underestimation is the more serious error because it may lead to underinvestment by the regulated companies. These considerations are taken into account in the Commission’s judgment… The Commission has used the 75th percentile of the WACC distribution…”

The AER’s WACC review has potentially profound immediate and long-term implications for the Australian electricity network sector, a sector which has been designated by the Department of Resources, Energy and Tourism as a provider of “critical infrastructure”[6]. The review coincides with significant changes in energy markets and financial markets, and occurs at a time when significant levels of on-going investment will be required.

Given this context, it is essential that through this review the AER ensures that incentives are sufficient to continue to attract the required level of investment over the next decade and beyond. In particular, the review must carefully consider the costs and risks of under-investment in network infrastructure if the regulatory WACC is set too low[7].

Equally importantly, the review must also consider the setting of the regulatory WACC and its constituent parameters in the context of the profound changes occurring in global financial markets, and the on-going requirement for substantial capital investment in Australian energy infrastructure, particularly in response to climate change.

Global capital markets have exhibited extreme volatility in recent months. Global credit markets in particular are now widely described as being in “crisis”, with U.S. President Bush stating on 20 September 2008 that the United States economy was facing “unprecedented challenges” as a result of the situation in global credit markets. In a similar vein, the Governor of the Reserve Bank provided the following assessment in a speech he delivered on 17 September 2008,:

“We are living through challenging times for decision makers in both private and public roles. The past year has seen a major change in international economic and financial conditions. Global economic growth, having been well above average for a string of

5 Commerce Commission (New Zealand), *Gas Control Inquiry Final Report*, 29 November 2004, page 9.19.

6 This designation describes facilities which, if destroyed, degraded or rendered unavailable for an extended period, would adversely impact on the social or economic well-being of the nation or affect Australia's ability to ensure national security.

7 Section 7A(6) of the National Electricity Law states: “Regard should be had to the economic costs and risks of the potential for under and over investment by a regulated network service provider in, as the case requires, a distribution system or transmission system with which the operator provides direct control network services”.

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> years, has slowed noticeably, especially in the major industrial countries – yet inflation rates remain a concern. Large losses have been incurred by major international financial institutions. Several household names in global investment banking have disappeared. Appetite for risk – which had been strong to the point of recklessness in some areas – has given way to risk aversion. Credit is harder to obtain, and more expensive..."

The major structural changes that have occurred in global capital markets over the past year or so can be expected to continue to impact on investor confidence, world capital markets and global economic activity well into the period during which the Decisions from the AER's WACC review will take effect. As noted by the Reserve Bank Governor on 17 September, and in his Opening Statement to the House of Representatives Standing Committee on Economics (on 8 September 2008) the economy has entered a period during which investors are exhibiting an aversion to risk, and corporate boards are taking a much more cautious approach to capital allocation and funding decisions. In all likelihood, the economic conditions prevailing over the coming years will be substantially different from the preceding decades, when the appetite for risk was relatively high.

The AER's review should consider very carefully the down-side risks to investment incentives that would flow from any decision to reduce the regulatory WACC from the levels advocated in the submissions of the Joint Industry Associations. Indeed, the AER will need to consider whether the significant recent changes in global financial markets might well justify the application of a higher regulatory WACC, in order to ensure that adequate incentives are in place to continue to attract on-going investment in Australia's electricity networks over the immediate and longer-term future.

Quite apart from the very serious challenges posed by the global credit crisis, the electricity network sector must also respond to the need for increased investment associated with the continuing demand for energy from Australian businesses and households; the need to invest in energy infrastructure to support the continued growth of Australian export industries (particularly those supplying natural resources to the strongly-growing emerging economies of China and India); and the need to continue to replace and upgrade aging infrastructure.

At the same time, the sector must respond to the challenges of climate change, and the risks associated with the introduction of a Carbon Pollution Reduction Scheme and the expanded Renewable Energy Target Scheme. These initiatives are expected to result in significant restructuring in the production and delivery of electricity in Australia. This will have two separate impacts:

- On the one hand, investors may form a view that there are increased risks associated with investments in long-term network assets, given the uncertainty surrounding the production and delivery of energy over the immediate to longer term. This suggests that even at the present levels of regulatory WACC, investors may be increasingly cautious about committing capital to network investments that have payback periods of 40 years or more;

- On the other hand, it has been recognised that responding to the challenges of climate change is likely to lead to a need for more, not less, investment in network infrastructure. For instance, on page 427 of his Climate Change Review draft report, Professor Ross Garnaut stated:

> "A well integrated national energy network with the capacity to cope with potentially large shifts in energy flows will allow for structural change and the smoothing of shocks following the introduction of the emissions trading scheme…"

The challenges associated with these major structural shifts heighten the immediate and longer-term risks faced by investors in Australia's electricity networks. This consideration, in turn, underscores the need for the AER's WACC review to assess very carefully - and in accordance with the requirements of the National Electricity Objective - the impacts that its decision-making may have on investment incentives.

With the full support of SP AusNet, the Joint Industry Associations propose that in relation to the WACC parameters that are the subject of the AER's review:

- the nominal yield on 10 year Government bonds should continue to be the proxy for the nominal risk free rate;
- the previously adopted equity beta value of 1 should continue to apply, and should be applied consistently to both transmission and distribution networks;
- the previously adopted benchmark gearing ratio of 60% should continue to be applied;
- the previously adopted benchmark credit rating of BBB+ should continue to be applied; and
- the previously adopted Market Risk Premium (MRP) value of 6% should continue to be applied provided that a value of imputation credits ("gamma") of zero is applied, otherwise an MRP value of 7% should apply along with a gamma value of 0.2.

SP AusNet is confident that after considering the role and importance of the regulatory WACC in the wider context of the risks posed by climate change and highly volatile global capital markets, the AER will conclude that adoption of a WACC below the level advocated in the submissions by the Joint Industry Associations:

- would damage investment incentives, to the detriment of the long term interests of consumers of electricity; and
- therefore, would be contrary to the requirements of the National Electricity Objective.

In addition, SP AusNet is confident that the detailed submissions lodged by the Joint Industry Associations fully substantiate the WACC parameters advocated by the those submissions, having regard to all of the provisions of the National Electricity Law and Rules that govern the AER's WACC review.

The attachment to this letter sets out a summary of the WACC parameter values proposed by SP AusNet for the purpose of this review.

SP AusNet looks forward to further constructive participation in this important review, and we would be pleased to discuss with you any matter associated with the review at any time. Please call me directly on (03) 9695 6600 should you wish to discuss any matters arising in relation to your review.

Yours sincerely

CHARLES POPPLE
Acting Manager Director