Alinta Limited
ABN 40 087 857 001
Level 14, 1 O'Connell Street
Sydney NSW 2000
Australia
Telephone 02 9270 4600
Facsimile 02 9270 4601

12 June 2007

Mr Michael Walsh
Director
Network Regulation North Branch
Australian Competition and Consumer Commission
GPO Box 3648
Sydney NSW 2001

Dear Michael

Re: Dawson Valley Pipeline Draft Decision

Alinta appreciates the opportunity to respond to the Commission's Draft Decision for the Dawson Valley Pipeline (DVP) proposed Access Arrangement. Alinta does not have a direct interest in the outcomes of the review of the DVP Access Arrangement, but believes it is appropriate to raise with the Commission new evidence on the adequacy of Commonwealth Government Securities (CGS) to act as a proxy for the risk free rate. This evidence in two reports from NERA (attached) indicates that yields on CGS understate the risk free rate by up to 86 basis points, and so raise a very significant issue in relation to the estimation of the cost of capital. Alinta has become familiar with the NERA reports in its role as adviser to Multinet as part of Multinet's Access Arrangement review currently being undertaken by the Victorian Essential Services Commission. Given the broader significance of the NERA work for regulated businesses Alinta believes that it is appropriate that the Commission consider this new evidence in the course of the DVP Access Arrangement review.

The methodology for determining the risk free rate (in real and nominal terms) and the forecast inflation rate proposed by DVP is consistent with that applied by the ACCC in its previous decisions. This method involves the use of yields on indexed and nominal CGS and has accepted by the Commission in its Draft Decision and updated to reflect the market for the 20 day period ending 14 May 2007[1].

NERA has conducted an investigation on the CGS market and concludes that biases exist in the yields on CGS in relation to the actual risk free rate and these instruments no longer represent an adequate proxy for the risk free rate. These biases have been described in terms of a relative bias between indexed and nominal CGS and an absolute bias on nominal CGS. NERA has prepared two reports[2] on the biases which have been submitted to both the ESC in the Victorian Gas Access Arrangement Review, and the first of the two reports has been submitted to the AER as part of Powerlink's revenue cap review.

NERA's first report dealing with the relative bias finds that since 1996 there have been dramatic reductions in the supply of both indexed and nominal CGS as a consequence of reducing supply and increasing demand. NERA demonstrates that as a consequence there is a bias in the indexed CGS yields relative to nominal CGS, historically used as a proxy for the real risk free rate by Australian

[1] ACCC Draft Decision, page 46.
[2] NERA, *Bias in Indexed CGS Yields as a Proxy for the CAPM Risk Free Rate*, March 2007and NERA, *Absolute Bias in (Nominal) Commonwealth Government Securities, 7 June 2007*

regulators. It is demonstrated that there is a relative downward bias of 20 basis points between the yields on real and nominal 10 year CGS.

NERA's analysis builds on views expressed by the Reserve Bank of Australia (RBA) in recent reports about supply and demand effects in the market for CGS that mean the difference between yields on indexed and nominal CGS cannot be adequately explained by forecast inflation. The consequence is that both real and nominal CGS yields can no longer provide a sound estimate for the risk free rate.

NERA's second report on the absolute bias demonstrates that the absolute bias on the true risk free rate in the yield on nominal bonds is 66 basis points and using indexed bonds underestimates the real cost of equity in the order of 86 basis points. NERA identifies two approaches to correct for the identified biases, but recommends that instead of adjusting CGS market data, an alternative approach where the risk free rate is set equal to the yield on corporate bonds less the cost of insuring those bonds against default should be adopted.

While NERA has provided new evidence quantifying the biases in the market data, the findings are not new. As well as the RBA, the inadequacies of CGS yields as a proxy for the risk free rates have been identified within academic research generally and by regulators in the UK.

Alinta has reviewed this evidence and considers there to be a compelling case that continued use of CGS yields to estimate the risk free rate would result in a significant underestimate of the allowed cost of capital for regulated entities. Alinta submits that given the credibility of evidence set out in the NERA reports the Commission has compelling reasons to give serious consideration to them in assessing DVP's proposed WACC in the context of section 8.30 and 8.31 of the Gas Code.

Clearly the risk free rate is the foundation element of the CAPM based WACC and affects decisions about allowed revenues that can be earned by regulated businesses generally. Alinta recognises that an issue of such significance should be not normally be tested in a review for a relatively minor asset such as the DVP. However, the DVP Access Arrangement review provides an immediate formal opportunity for these important issues to be raised with the Commission as has already been raised with the ESC and the AER and should be part of a broader consultation with industry, regulators, policy makers and the AEMC.

In the meantime Alinta urges the ACCC to address this essential issue by investigating this new evidence as part of the DVP review process and to consider the possibility of broader consultation. If you would like further information on the above matters, please contact Chris Harvey, Manager Regulatory Development on 02 9270 4557.

Yours sincerely

Sandra Gamble
Manager Regulatory