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Our Reference: UE SU 01

Mr. Steve Edwell
Chairman
Network Regulation South Branch
Australian Energy Regulator
GPO Box 520
Melbourne VIC 3001

Dear Steve

United Energy's submission to the AER's review of the weighted average cost of capital parameters

United Energy welcomes the opportunity to make this submission in response to the Australian Energy Regulator's (AER) explanatory statement and proposed statements on the weighted average cost of capital (WACC) parameters, which were published by the AER on 12 December 2008.

United Energy strongly supports the submission prepared by the Joint Industry Association. The purpose of this further submission is to focus specifically on the broader context in which this WACC review is being conducted, particularly in relation to the global financial crisis; the new investment to address climate change; and investor expectations.

In broad terms, United Energy is extremely concerned that the AER's WACC decision is inconsistent with the Rules and the National Electricity Law. The attachment to this letter explains in detail why United Energy believes that the AER's WACC decision:

- misapplies the capital asset pricing model (CAPM) by adopting an overly narrow and mechanistic approach that is inconsistent with the Rules and the National Electricity Law;
- has created a less stable and unpredictable regime from the perspective of investors and financial markets;
- imposes unexpected changes to the WACC methodology;

- stifles the desire and capacity to innovate and invest in leading edge technologies and processes that are urgently required to address climate change; deliver smart 2-way grids and meet the needs of embedded generation;

- misunderstands the nature of investment decision making and the commercial reality of stranded asset risk and technological obsolescence; and

- inappropriately discounts the importance of the global financial crisis and its impact on the forward looking costs of capital.

The attachment also provides specific commentary of some of the WACC parameters where appropriate. United Energy notes that the Joint Industry Submission provides further detailed commentary from WACC experts.

United is also concerned that the AER has inappropriately discounted the significance of the global financial crisis and substantially disregarded the need to encourage network investment to enable the sector to respond effectively to climate change. The AER wrongly cites the network service Provider's (NSP's) protection from stranded asset risk as a justification to discount the significance of the above issues. United Energy does not accept that the Rules can insulate NSPs from the commercial realities of stranded asset risk, and even if the Rules did offer such protection, it would not provide justification for discounting the above issues.

The Rules and the National Electricity Law impose overarching objectives on the AER that should preclude the regulator from taking a narrow mechanistic approach to the cost of capital at the expense of the statutory objectives. These overarching objectives recognise implicitly that CAPM is a theoretical model, and the choice of each parameter value in isolation must be tempered by a broader appreciation that the purpose of regulation is to promote efficient investment. A detailed discussion is provided in the attachment to this letter, but it is useful to make two comments here:

- Clause 6.5.4(e)(1) of the Rules states that in conducting its WACC review, the AER must have regard to the need for the rate of return calculated to be a forward looking rate of return that is commensurate with prevailing conditions in the market for funds and the risk involved in providing distribution services. This clause precludes the AER from examining the WACC parameters and applying the CAPM formula in a vacuum, without regard to the current economic climate and investors' expectations in that current climate; and

- The current WACC review is the single most important regulatory decision to be undertaken by the AER under the new regulatory framework. The Expert Panel on energy access pricing, which was established by the Ministerial Council on Energy to design the current regulatory regime, highlighted the importance of a well understood and predictable regulatory regime[1]. This emphasis on predictability is reflected in the drafting of the Rules, which only allow the AER to amend the WACC parameters if there is persuasive evidence to do so.

United Energy believes that the AER's proposed WACC parameters are likely to create a disincentive for pursuing new investment, and create real challenges for some distributors (including United Energy) in obtaining new debt and equity to fund necessary capital expenditure.

1 Expert Panel on Energy Access Pricing Report to the Ministerial Council on Energy, April 2006, pages 55 and 59

In this context, United Energy is very concerned and disappointed that the AER's explanatory statement on the WACC has:

- failed to calculated a forward looking rate of return that is commensurate with prevailing conditions in the market for funds, contrary to the requirements of Clause 6.5.4(e)(1); and
- delivered reductions in the WACC by changing the methodology, rather than examining changes to actual market conditions or market data. Importantly, the WACC methodology had previously been regarded as stable, reflecting consistent regulatory decisions over many years. Furthermore, an examination of the recent changes to actual market conditions and data would justify an increase in the WACC parameters from those previously adopted in regulatory determinations.

The degree to which industry analysts were surprised by the draft decision on the WACC parameters is especially noteworthy for the following reasons:

- WACC parameters have been examined on many occasions by industry regulators and therefore equity market analysts are very familiar with the key issues, and have understood the methodology to be settled/stable;
- Academic papers that discuss the latest empirical research on WACC parameters and test finance theories are publicly available; and
- The timing and scope of the AER's WACC review is clearly defined by the Rules and the National Electricity Law and has been well anticipated by analysts. The expected outcome from the WACC review should therefore have already been factored into market data.

Whilst the AER asserts in its explanatory statement that its proposed WACC parameters have been set with regard to the global financial crisis, it is evident from the above outcome that this is not the case. In reality, the AER has not given adequate consideration to the real-world impact of the financial crisis, such as the increase in the forward-looking market risk premium.

The immediate reaction of the financial markets to the AER's approach to WACC is not the principal concern that United Energy highlights. More importantly, investor perceptions regarding regulatory risk will ultimately be reflected by company Boards seeking strategies to minimise capital expenditure and ration funds[2]. Such a direction is considered inconsistent with Australia's current needs; inconsistent with government policies; and inconsistent with the National Electricity Objective in the National Electricity Law.

Further, there is every likelihood that if the draft decision is to prevail, the substantial change to Australia's electricity networks and electricity network businesses that will be needed to help facilitate the industry's response to climate change, will not be successful.

If Australia is to meet its policy objectives in respect of climate change, there will necessarily be substantial change in the nature and role of electricity distribution

2 In this regard, it is instructive to note that the Essential Services Commission's recent WACC decision for Multinet Gas Networks has led to an immediate decision to reduce capital expenditure by 30 per cent, cutting the pipe renewal program that had been running for some 5 years, to a bare minimum.

businesses. Existing network infrastructure, the fundamental design and configuration of which has remained unchanged for many decades, will need to be rethought and reconfigured to cope with the 2-way electricity flows and other electrical issues that come from embedded generation. This challenge should not be underestimated, and will require significant forward thinking, innovative problem solving, and timely capital investment.

If the businesses are entrenched in a world of survival and capital rationing, it is hard to see that challenge being met. Making distribution networks “two way flow ready” will be a major process that will take a long time to implement, and if the industry do not start the process early it will have to turn away embedded generators down the track, and the country’s climate change objectives will not be met.

It is worth noting that the electricity distribution sector’s first contribution to aiding climate change policy, smart meters, is already changing the nature of the businesses[3].

Not only will the constrained capital environment impact on our response to climate change, but also other discretionary and innovative investment is likely to be impacted. This may include the development of new interstate transmission interconnectors, the renewal of aging assets and the development of the innovative smart networks of the future, now being discussed around the world – (including upgrading networks to meet the evolving needs of consumers). The nature of this investment is such that it cannot be directed by Government or regulators through compliance obligations.

Overall, the AER’s WACC decision is likely to stifle the desire and capacity to invest for the future, in much the same way that airport regulation under the CPI-X regime stifled investment and led the Government to replace that framework with a price monitoring regime.

I would be pleased to discuss this submission with you at your convenience.

Yours sincerely

Hugh Gleeson
Chief Executive Officer

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[3] In United Energy’s case AMI represents a increase to the RAB of more than 30 per cent, with that investment being in high technology, (relatively) short life assets with significant risk of technology obsolescence, being overlayed on an existing asset base and business culture base on 40-70 year asset lives, low asset turn over, low technology, low risk assets.

Attachment

United Energy's Comments on the AER's WACC parameters

As outlined in the covering letter, United Energy is concerned that the AER's WACC decision:

- misapplies the CAPM by adopting an overly narrow and mechanistic approach that is inconsistent with the Rules and the National Electricity Law;
- has created a less stable and unpredictable regime from the perspective of investors and financial markets;
- imposes unexpected changes to the WACC methodology;
- stifles the desire and capacity to innovate and invest in leading edge technologies and processes that are urgently required to address climate change; deliver smart 2-way grids and meet the needs of embedded generation;
- misunderstands the nature of investment decision making and the commercial reality of stranded asset risk and technological obsolescence; and
- inappropriately discounts the importance of the global financial crisis and its impact on the forward looking costs of capital.

Each of these matters is explained in further detail below.

1. Misapplication of CAPM

The Rules require the AER to review the WACC parameter values within the CAPM framework. However, whilst this task requires a detailed examination of each WACC parameter, the Rules and the National Electricity Law impose an overarching set of objectives, specifically:

- The National Electricity Law requires that the AER must exercise its functions or powers in a manner that will or is likely to contribute to the achievement of the National Electricity Objective.
- The National Electricity Objective is to promote efficient investment in, and efficient operation and use of, electricity services for the long term interests of consumers of electricity with respect to:
  - price, quality, safety, reliability and security of electricity, and
  - the reliability, safety and security of the national electricity system.
- The National Electricity Law also includes revenue and pricing principles, which include the following requirements:
  - regard should be had to the economic costs and risks of the potential for under and over investment by a regulated network service provider; and
  - that a regulated network service provider should be provided with a reasonable opportunity to recover <u>at least</u> the efficient costs the operator incurs.
- The Rules require that the AER must have regard to the need for the rate of return to be a forward looking rate of return that is commensurate with prevailing conditions in the market for funds and the risk involved in providing prescribed transmission services or standard control services (as the case may be).

- The Rules require that the AER must have regard to the need for the return on debt to reflect the current cost of borrowings for comparable debt.

- The Rules require that where a value, method or credit rating level cannot be determined with certainty the AER's WACC review must have regard to:

  – the need to achieve an outcome that is consistent with the National Electricity Objective, and

  – the need for 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.

To summarise, the overarching objectives in the National Electricity Law and the Rules preclude the AER from adopting a narrow and mechanistic approach to this WACC review. Importantly, these overarching objectives reflect Government policy, informed by stakeholder consultation through the detailed work of the Ministerial Council on Energy and the Expert Panel on energy access pricing. The current regulatory framework seeks to promote efficient investment by:

- providing investors with a reasonable opportunity to at least recover efficient costs;

- delivering a stable and predictable regulatory regime with low regulatory risk; and

- separating the roles of Rule-maker (the AEMC) from the Rule-enforcer (the AER) and adopting a 'fit for purpose' approach to constraining regulatory discretion.

United Energy notes that the concepts of promoting efficient investment and providing a stable and predictable regulatory regime are not new. In relation to WACC, all regulators in Australia to date have taken an holistic approach to CAPM that recognises the importance of regulatory precedent and investor certainty. Regulators have considered the broader regulatory objectives and avoided an examination of each WACC parameter in isolation. Accordingly, a broad consensus regarding the WACC parameters methodology for their development had developed across jurisdictional regulators in the energy sector. The AEMC explained that the Rules for electricity transmission networks were intended to codify this consensus and further reduce uncertainty[4]:

> "There has been widespread acceptance of the capital asset pricing model (CAPM) as the analytical basis for estimating the regulatory cost of capital. Although there has been ongoing debate about the parameter values used by the regulator to estimate the WACC at each revenue reset, there has been a high degree of stability in the parameter values adopted by the regulator in recent years. Considering these circumstances the Commission believes that the cost and uncertainty associated with continually reopening both the methodology and parameters at each revenue cap review is unwarranted in terms of any potential benefits and the administrative costs.
>
> Providing short term stability regarding the WACC determination reduces an important source of potential variability in regulatory decision making thereby providing a more certain and predictable environment for investment and financing decision making. This is consistent with the approach adopted by the AER under the SRP, however, this was an administrative document which could be departed from at any time. The provisions codified in the Revenue Rule therefore largely represent current practice. However, it is also recognised that the methodology and parameters for the cost of capital are matters that the

[4] AEMC, Economic Regulation of Transmission Services, Rule Determination, November 2006, page 82.

> regulator must be able to review periodically and to exercise discretion and judgement as to whether there is a case for change."

Against this background, United Energy considers that the AER's overall conclusions on the cost of capital reflect a significant departure from prior regulatory practice. Specifically, the AER has proposed the following changes to previously determined WACC parameters, each having a negative financial impact on electricity network companies:

- The equity beta will be reduced from 1.0 to 0.8;
- The value of imputation credits (gamma) will be increased from 0.5 to 0.65;
- The benchmark credit rating will be been increased from BBB+ to A-; and
- The term of the risk free rate will be reduced from 10 years to 5 years, so that it matches the 5 year regulatory period.

It is particularly noteworthy that these four changes in combination is the most wide-ranging change proposed by any energy regulator in Australia. As discussed in further detail below, these changes have occurred at the most inopportune time as the global financial crisis deepens.

United Energy considers that the AER's conclusions on WACC reflect an overly narrow and mechanistic approach to the WACC review, and has examined the individual WACC parameters in isolation from the broader objectives mandated by the Law and the Rules. It is widely acknowledged, for example, that idiosyncrasies within CAPM must be recognised in its application, especially where the empirical data does not accord with the theory. For example, the AER employs empirical data from dividend drop-off studies to inform the choice of gamma even though the standard CAPM in the Rules employs tax assumptions that are inconsistent with the real world. The AER discusses this issue in the following terms on page 337 of the explanatory statement:

> "In sum, the empirical evidence strongly suggests that differential taxation should be taken into account in interpreting dividend drop-off studies (i.e. the model which estimates the price drop-off on ex-dividend days). While this would seem to present an apparent inconsistency with the standard CAPM (which assumes no differential taxation), based on Handley's advice there is no conclusive evidence that differential taxes should be incorporated into the CAPM (i.e. the model which estimates returns)."

In United Energy's view, this type of inconsistency should be addressed by the AER in light of the overarching objectives in the Rules and the National Electricity Law, which are intended to provide a stable and predictable regulatory regime in order to promote efficient investment. In relation to gamma, for example, the AER has instead adopted a value (0.65) that is substantially higher than prior regulatory practice, even though the expert evidence submitted by the JIA strongly indicates that gamma should be reduced significantly. United Energy does not accept that such an approach accords with the spirit or the letter of the National Electricity Law or the Rules.

United Energy urges the AER to re-examine its findings in relation to the cost of capital, having proper regard to investors' reasonable expectations and the forward looking cost of capital in the context of the global financial crisis. As explained later below, it is also essential that the AER understands the changing nature of investment – innovative investment in leading edge technology with higher risk of obsolescence – and the implications of this new investment for the benchmark cost of capital and businesses' investment decisions.

United Energy understands that other stakeholders (including the Joint Industry Association) will make submissions to the AER explaining how these broader matters should be reflected in the specific WACC parameters. In reviewing these submissions, United Energy urges the AER to consider the overarching objectives for the WACC review.

2. Adverse market reaction to the AER's WACC statement

As noted above, United Energy considers that the AER has erred by taking an overly narrow and mechanistic approach to CAPM. In doing so, the AER has not properly considered the need for a stable and predictable regulatory regime. This observation is clearly evident from the reaction of the financial markets to the AER's WACC review.

Specifically, the reaction of the equity market immediately after the publication of the AER's draft proposal was negative. At 11 am on 12 December, while the All Ordinaries Index was down 1.6 per cent on its closing value of 11 December:

- The share price of SP AusNet (the owner of Victorian electricity transmission and distribution and gas distribution networks) was down 6 per cent.

- The share price of Spark Infrastructure (the owner of the electricity distribution networks of CitiPower, Powercor and ETSA Utilities) was down 8.7 per cent.

- The share price of DUET (the owner of Victorian gas and electricity distribution networks, among other assets) was down 5.5 per cent.

One week later (at the close of trading on 19 December), the All Ordinaries Index had risen 0.4 per cent compared to its closing value of 11 December (immediately prior to the AER's announcement). By comparison, SP AusNet's share price was down 10.5 per cent on its 11 December closing value, Spark was down 7 per cent and DUET was down 1.4 per cent.

The key message from the equity market reaction is that industry analysts were surprised by the AER's WACC decision. The degree to which analysts were surprised is especially noteworthy for the following reasons:

- WACC parameters have been examined on many occasions by industry regulators and therefore equity market analysts are very familiar with the key issues;

- Academic papers that discuss the latest empirical research on WACC parameters and test finance theories are publicly available; and

- The timing and scope of the AER's WACC review is clearly defined by the Rules and the National Electricity Law, and therefore should have already been factored into market data.

Notwithstanding the broad understanding of the relevant issues and the public availability of data and academic literature, the AER's WACC decision surprised the equity markets. This observation confirms that the AER's WACC decision is unprecedented in Australia. It also provides the clearest signal to the market that the regulatory regime is much less predictable and stable than previously believed.

3 Methodological change

A further important aspect of the perceived instability in the regulatory regime is that the AER has substantially derived its WACC parameter downgrades via methodological change, rather than from any observations of market data changes that would warrant such downgrades. In fact, the opposite would appear to be most relevant – that is the overwhelming majority of evidence regarding changes in market conditions in this WACC review points to the need to increase the WACC.

Absent evidence of changes in market conditions or market data that warrant a reduction in the WACC, the changes proposed by the AER are substantially derived from methodology change. In particular:

- In relation to gamma, the AER has assumed that the payout ratio is 1 and therefore has departed from the previously accepted Monkhouse approach.

- In relation to the term of the risk free rate, the AER has moved from a 10 year term to a 5 year term, even though 10 years was adopted by the Australian Competition Tribunal in the 2003 GasNet decision.

- In relation to the benchmark credit rating and the debt premium, the AER has moved away from accepted regulatory practice that the benchmark network company should be standalone and privately owned.

In relation to the final point, United Energy notes that the survey used by the AER to determine the benchmark credit rating contains a number of businesses which have either implicit or explicit parental support. Credit rating agencies typically take account of the balance sheets of parents, and the likelihood that parents will support businesses if those businesses fall into need. The rating agencies will assume such a support even if there are no specific contractual arrangements in place and the child businesses are legally ringfenced.

This issue of implied parental support is likely to occur for all government owned businesses, and businesses which are subsidiaries of significant parents such as the CKI owned utilities or SPI owned utilities. The AER's approach to determining the credit rating is contrary to long-standing regulatory practice and was only recently settled for transmission companies by the AEMC[5]. This example illustrates the extent to which the AER's WACC review has given practically no weight to existing regulatory precedents.

In looking at other changes, the AER's conclusion that it should no longer accept the Australian Competition Tribunal findings in relation to GasNet is especially surprising.

In summary, the AER's proposed changes to the WACC parameters appear to be substantially derived from changes to the WACC methodology, and this creates significant uncertainty for investors and signals a less predictable regulatory regime for the future. Investors formed reasonable expectations through numerous regulatory determinations that the basic WACC methodology issues had been settled. The decision by the AER to reverse standard regulatory practice is very damaging to investor confidence.

United Energy believes that the AER's approach fails the requirement of the Rules and the National Electricity Law on two counts:

- Firstly, the persuasive evidence test in the Rules is firmly based on decisions by the Ministerial Council on Energy and the AEMC to deliver a stable and predictable regulatory regime where the WACC parameters are periodically updated to reflect changes to the market data. The Rules were not intended to allow the AER to deliver substantial and unexpected changes to the WACC methodology without new evidence to support that change;

5 See AEMC, Draft Rule Determination, July 2006, Chapter 5 for a detailed discussion of the issues.

- Secondly, the National Electricity Objective is focused on promoting efficient investment. The prospect of unpredictable shifts in the WACC methodology through 5 yearly AER reviews is inimical to encouraging efficient investment in network assets with long asset lives and therefore is contrary to the National Electricity Objective.

4. Stifling the desire and capacity to invest and innovate

For a traditional energy network company, the AER's current WACC decision would naturally have negative consequences for new investment. For example, as a consequence of the Essential Services Commission's recent gas access arrangement review that reduced the equity beta, capital expenditure plans for Multinet Gas Networks have been cut by 30 per cent, with the business curtailing a major pipe renewal program that has been running for 5 years, down to essential minimum levels only. As explained above, United Energy's strongly held view is such outcomes are inconsistent with the regulator's statutory objectives.

Furthermore, the nature of electricity network investment is changing rapidly to meet the challenges of the 21st century. In particular, the traditional poles and wires business using the same know-how for many decades will be augmented by smarter technologies and a new mindset that the grid should be 2-way. To deliver such substantive change, network companies must invest in new technologies, processes and people in the following areas:

- Climate change – to deliver a smarter grid so that networks and customers can be more responsive to environmental needs;

- Inter-regional interconnectors (i.e. electricity transmission lines between states) to improve reliability and reduce costs to customers; and

- More efficient networks that better meet the needs of consumers – noting that in this technological age the needs and expectations of end consumers are increasing more rapidly than ever in the areas of reliability and quality of supply.

In relation to climate change, the required distribution investment involves both innovation and long lead times – and cannot simply be addressed by imposing a compliance obligation on distributors to build for climate change. Similarly, the rapid and continued growth in embedded generation will create new challenges for network businesses as network flows change dramatically. The quantum of capital expenditure required to meet these challenges – including the reconfiguration of the network – is inherently uncertain, but it is likely to be substantial.

The nature of this new investment presents challenges to the network companies and to the current regulatory framework. Networks must first have the foresight to anticipate the required outcomes and develop plans accordingly. This foresight depends on investment in smart people to anticipate change and develop plans to respond to it. The planning and development phase must be supported by Investment in leading edge technologies and new processes, which differ markedly from traditional investment in poles and wires. It is now accepted that world leaders in distribution networks are those who innovate; who implement smart grids; and who drive high technology solutions. The investment must start now if the new long-term challenges are to be met.

The challenge for the regulatory framework is that this innovative investment cannot be defined and regulated in the traditional way, either in terms of defining the inputs (e.g. numbers of transformers replaced) or in terms of defining the short, medium and long-term outputs (e.g. a target level of reliability). In fact, the nature of innovative investment is such that it cannot be directed by the regulator or Government. Government's role is to set the broader policy objectives and create the right environment for businesses and individuals to respond.

In order for the Government's policy objectives to be met and for Australia to enjoy the benefits, there is a need for great change in network business. To a substantial degree, the specific details of those changes are not yet known and must be developed carefully over a sustained period. Inevitably, the changes will require investment in smart people motivated by the businesses to think ahead and develop innovative solutions. Eventually, these efforts will deliver benefits to consumers and the wider Australian economy – but crucially it all depends on creating the right commercial environment.

As a practical matter, if the AER's WACC decision creates capital constraints for the businesses then these businesses will not be motivated to drive the necessary changes. Instead, the businesses will be focused on bridging the gap between the AER's WACC parameters and the actual requirements of the financial markets. In simple terms, the network businesses will switch from innovation to commercial survival.

United Energy notes that the regulatory challenges of creating the environment for innovative investment are not new. The recent Australian experience of airport regulation has demonstrated unequivocally that innovative investment can flourish if the right commercial conditions are established. By the same token, the wrong form of regulation can stifle investment – which is precisely why the Government has moved airports away from CPI-X regulation to a price monitoring regime. In its review of airport regulation in 2006, the Productivity Commission summed up its findings in relation to investment in the following terms[6]:

> "Basically, the reason the current regime has improved the investment climate is because the regulator is no longer directly involved in decision making. Given the pivotal role of capital in enhancing and sustaining airport services, the improved investment environment delivered by the light handed approach is a very important benefit. It will be a source of further gains as a number of the major airports move into a new phase of the investment cycle."

Whilst United Energy is not presently advocating a fundamental change in the regulatory regime for electricity networks, the lessons from airport regulation are pertinent to the current WACC review. In particular, regulation should provide electricity network companies with sufficient scope to respond to the new challenges of the 21st century. By historic standards, the needs of electricity network customers are changing very rapidly, not least because of climate change and the development of new, smarter technologies. The capacity of network companies to invest and innovate is potentially significant, but the commercial environment must facilitate it in much the same way as airport regulation.

United Energy is particularly concerned that the AER's current WACC decision will stifle network owners' desire and capacity to innovate. At present, the AER's WACC decision is drafted as if all network investment will continue to be traditional poles and wires, and does not need to invest in smart people and technologies to bring about substantial change. With this mindset having been adopted, the AER's proposed benchmark cost of capital will create capital rationing and will, as a practical matter, preclude any substantial investment outside the traditional network activities.

5 AER misunderstands the nature of investment decision making

On page 4 of its explanatory statement, the AER comments that the regulatory regime ensures that there are minimal risks to investors:

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6 Productivity Commission, Review of Price Regulation of Airport Services, 14 December 2006, page 33.

> "Electricity NSPs are adequately compensated through the regulatory regime for the scope and costs of new investment driven by demand growth, ageing assets, and other factors impacting on their expenditure requirements. The AER notes there are a number of features of the regulatory regime which minimise the risks associated with long lived assets (e.g. there is no asset stranding risk, the regulated cost of debt reflects market conditions and the asset base is not periodically revalued). It is expected that the outcomes of this review will continue to provide returns for NSPs which are sufficient to attract and compensate for both equity and debt funding."

The AER' statement implicitly assumes that the Rules can simply remove stranded asset risk, and this will ensure that investment funds continue to flow to network companies. United Energy considers that this assumption does not reflect the commercial realities of obtaining funding for new investment.

In this regard, United Energy disagrees with the AER's assertion that there is no risk of asset stranding. United Energy does not believe that the Rules provide any guarantees that businesses can continue to recover the cost of assets that are rendered obsolete. Further, if the Rules did offer such protection, it would not create the environment of investment certainty/confidence the AER alludes to – as investors would be unlikely to have confidence that such a rule would remain unchanged, and be able to work when/if needed in the future.

As we move into an environment of high technology assets, the risks of assets becoming redundant or obsolete and needing to be replaced before the end of their accounting lives becomes more likely. It is noted that for United Energy the AIMRO program pay $350m technology program build on top of a $1b RAB, i.e. there is now a 35 per cent increase of the RAB based on new high technology assets which have a real potential for becoming redundant in a short period of time, well ahead of the end of their accounting lives. This 35 per cent addition makes the regulatory asset base very different from what it was a few years ago where assets were long life, low technology, very low rate of change type assets. Therefore the real risk of asset stranding is greatly increasing over time.

The issue of climate change further increases this stranded asset risk. This happens in two ways:

- Certain assets may no longer be needed as people abandon electricity, or abandon use of the electricity grid, or on a widespread basis; and

- The type of investment to support dynamic multi-directional networks; respond to climate change; and facilitate embedded generation will be higher technology assets, and therefore are subject of technology risk and stranding risk.

As noted above, it is doubtful that investors will be able to invest in leading edge technologies; innovative network design; and smart grids if the regulatory environment is considered to be unpredictable and the benchmark cost of capital has been substantially reduced.

6. Impact of the global financial crisis

In its draft decision, the AER has taken the position that it should "take a long term perspective in setting the rates of return". In effect, the AER looks through the current financial crisis, and adopts WACC parameters for the period on the assumption that the crisis will abate. United Energy believes that this approach is flawed in two respects:

- It has been long standing regulatory practice to take the market parameters "on the day" – on the basis that today's market parameters are the best view of the market. It is not for the

AER to second guess the market and make assumptions as to what may happen in the future. This long standing regulatory practice is right, and the AER's approach of assuming today's market is not the best view, is a flawed approach.

- The AER's approach seems to be to take its subjective judgment as to the average market parameters over the 2010-2019 period – being the period for which this decision applies. However, there are many businesses who will be subject to these WACC parameters in 2011 and must raise capital in 2011 based on the WACC parameters set by the AER in this decision, to allow them to fund investment required in that year. Even if the AER's forecast of the future is correct, and the market has recovered by 2015, that is of no help to support investment that is needed in 2011. Again, this fails the National Electricity Objective and revenue and pricing principles in the National Electricity Law.

On a more detailed matter, United Energy notes that the Rules require that the AER must have regard to

> "the need for the rate of return to be a forward looking rate of return that is commensurate with prevailing conditions in the market for funds and the risk involved in providing prescribed transmission services or standard control services (as the case may be)"

Whilst the AER has acknowledged that the debt premium is substantially higher as a result of the global financial crisis, the AER does not accept that the cost of equity has also increased. Specifically, whilst reported historic returns may imply that the market risk premium (MRP) has fallen as a result of the global financial crisis, this evidence is contradicted by the financial markets which indicate that forward looking estimates of the MRP have increased dramatically. The AER has substantially disregarded this evidence. United Energy notes that the AER has an obligation to adopt a forward looking estimate of MRP.

United Energy accepts that forward looking estimates of the market risk premium can be difficult to establish – but that is the task the AER has been given. United also acknowledges that in the past long-term historical averages have been used as a proxy for forward looking estimates. However, it is well documented that the current market conditions are definitely not normal (rather they are unprecedented), and as such, at this point in time historical averages do not represent a valid proxy. The AER would be failing in its duty if it did not take proper account of the forward looking MRP estimates in setting the benchmark WACC.

7 SUMMARY

In summary, the AER's proposed WACC parameters make practically no allowance for the new commercial realities facing network companies or the overarching objectives in the Rules and the National Electricity Law. United Energy strongly urges the AER to reconsider its conclusions regarding the cost of capital.