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19 June 2008

Dr John Tamblyn
Chairman
Australian Energy Market Commission
Level 5, 201 Elizabeth Street
Sydney NSW 2000

via e-mail: submissions@aemc.gov.au

Dear Dr Tamblyn,

WACC Parameter Values – Equity Beta and Gamma

Thank you for the opportunity to make a submission with regard to the Energy Users Association of Australia's request for Rule change dated 21 April 2008 (**EUAA Rule change proposal**).

ETSA Utilities, CitiPower and Powercor (**the Businesses**) are opposed to the Rule change proposed by the EUAA and consider that the proposed reduction of the deemed values of the equity beta and value of gamma will not contribute to the National Electricity Objective (**NEO**). The Businesses therefore submit that the Australian Energy Market Commission (**AEMC**) should decline to make the Rule changes sought.

The Businesses note that the Australian Energy Regulator (**AER**) has proposed expedited Rule amendments that would bring forward and align the distribution and transmission WACC reviews. This would mean that these reviews would be concluded by 31 March 2009.

Problems with the EUAA Rule change proposal

The rationale put forward by the EUAA in support of its Rule change proposal can be summarised as:

- 'The Current Parameter Values do not reflect the best estimate of the true value of these parameters' and are therefore likely to result in over recovery of revenue and higher prices for electricity (page 5).

- The proposed amended parameter values 'provide a better estimate of the true equity beta and the true utilisation of imputation credits' (page 4) and will therefore give rise to more efficient pricing;
- The Competition Tribunal's decision in *Telstra Corporation (no.3) (2007) ATPR 42-160* supports the adoption of the EUAA's proposed amended parameter values;(page 6-7);
- Efficient pricing will contribute towards the NEO because 'economic activity will not be distorted by service providers earning revenues in excess of their economic costs' (page 17).

It is trite and uncontroversial for the EUAA to state that inflated values for WACC parameters being used in a regulatory price determination would result in:

- An over-recovery by regulated businesses (as compared with an efficient level); and
- Higher consumer prices for electricity.

Obviously such a result will only arise if the Current Parameter Values are in fact inflated, or alternatively, are not best estimates of true value. On the contrary we submit that:

- the Current Parameter Values are 'best estimates of true value' and the EUAA has merely presented selected arguments supporting a different best estimate without providing a balanced assessment;
- the Current Parameter Values have not been artificially inflated,
- this Rule change is seeking to pre-empt an established public process that has been designed to allow periodic review of these established 'best estimates' and to 'take account of changes in financial market conditions and developments in finance theory and practice'¹, and
- the EUAA Rule change proposal undermines the regulatory certainty provided by the Rules.

Best estimates of true value

The Current Parameter Values are indisputably values that have been accepted by a number of Australian economic regulators in a series of regulatory decisions as 'best estimates'. Attachment 1 shows that the median values for equity beta and gamma accepted by Australian economic regulators for electricity transmission and distribution are 1.0 and 0.5 respectively. The EUAA has not provided persuasive evidence that the current parameters have not been set on the basis that they are 'best estimates' of the true value of each component, but rather presents selected arguments supporting a different 'best estimate'.

¹ AEMC Rule Determination 'Economic Regulation of Transmission Services' 16 November 2006 page 82.

The EUAA Rule change proposal therefore does not substantiate its allegation of a 'problem with the existing Rule', other than it disagrees with the current best estimate of these parameters. In our submission this is insufficient basis to justify a Rule change application.

Not Artificially Inflated

The decision of the Competition Tribunal in *Telstra No.3* relates to a specific situation and in our view does not support the EUAA's position. The Tribunal's decision:

- relates to the 'reasonability' of a proposed access undertaking submitted by Telstra Corporation Ltd in the context of Part IX of the *Trade Practices Act 1974 (TPA)*, which is a telecommunications access specific access regime with its own industry specific statutory objectives; and
- was in the context of Telstra having used two values for WACC when determining its cost of supply, as well as having expressly adjusted the WACC 'by the addition of an amount equal to one standard deviation to allow for an alleged asymmetry in the social consequences of errors made in estimating the WACC'².

The matters to which the ACCC (and Competition Tribunal) must have regard in deciding whether an access undertaking is reasonable under section 152AH of the TPA are different from those that are relevant to the AEMC in considering this Rule change. In particular section 152AH of the TPA does not include any reference to the need to encourage investment, although this concept is included as a subsidiary issue under the objects under section 152AB of Part IX TPA.

This position can be contrasted with the NEO which has the need to promote efficient investment as a central issue stating:

The national electricity market objective is to promote efficient investment in, and efficient use of, electricity services for the long term interests of consumers...'

Further, the Current Parameter Values clearly do not include alternative WACC values for particular classes of assets and certainly do not include any 'artificial' uplift component.

The EUAA's quote from the decision of the Tribunal relates to the specific circumstances of that case and does not support the EUAA's contention that the Tribunal's comments are equally applicable to the estimation of equity beta and gamma under the Rules (page 7).

Established Public Process

The Ministerial Council on Energy has endorsed a '5 year binding review' for WACC parameters and methodologies, including in its SCO Response to Stakeholder Comments of the Exposure Draft of the NER³. Similarly the AEMC has concluded:

'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 parameters values adopted by the regulator in recent years. Considering these circumstances the Commission agrees that the cost and

² Telstra Corporation Ltd (No 3) [2007] ACompT 3, Summary para 9.

³ 1 August 2007

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.’⁴

The clear regulatory intent underlying the Rules is therefore that the parameters be only reviewed once every 5 years and that this will be a public process undertaken by the AER.

Further, when the AER conducts its review of rate of return parameters for both distribution and transmission the Rules make it clear that ‘persuasive evidence’ is required before any change is made to any of the Current Parameter Values that cannot be determined with certainty.⁵ The EUAA Rule change proposal is therefore inconsistent with both the regulatory intent and substance of the Rules.

Why the EUAA Rule change proposal does not promote the NEO

The NEO is ‘to promote efficient investment in, and efficient use of, electricity services for the long term interests of consumer of electricity and the reliability, safety and security of the national electricity system.’

A key component in promoting ‘efficient investment’ is providing a regulatory environment that provides a high degree of regulatory certainty. This has been recognised by regulators on numerous occasions including by the AEMC when, in affirming its decision to adopt the current WACC parameters and a 5 yearly AER review of these parameters, it stated:

“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 investing 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 also recognised that the methodology and parameters for the cost of capital are matters that the regulator must be able to review periodically and to exercise discretion and judgment as to whether there is a case for change⁶.

The EUAA Rule change proposal undermines the regulatory certainty provided by the Rules and, should it be accepted, opens the door to multiple such Rule changes as different stakeholders pursue their favoured position. Such an outcome would be:

- Contrary to the MCE and AEMC regulatory model that envisages once 5 yearly reviews of the WACC parameters by the AER;

⁴ AEMC Rule Determination ‘Economic Regulation of Transmission Services’ 16 November 2006 page 82

⁵ Clause 6.5.4(4) [distribution]; cl. 6A.6.2(j)(ii) [transmission].

⁶ AEMC Rule Determination ‘Economic Regulation of Transmission Services’ 16 November 2006 p.82.

- Contrary to the existing requirement under the Rules that the existing applicable Current Parameter Values not be varied unless there is 'persuasive evidence' support such a variation; and
- Contrary to concept of regulatory certainty and therefore entirely inconsistent with the NEO.

Please do not hesitate to contact Rolf Herrmann on 03 9683 4282 or Eric Lindner 08 8404 5694 on to discuss.

Yours sincerely

[Signed]

Rolf Herrmann
A/GENERAL MANAGER REGULATION
CitiPower and Powercor

[Signed]

Eric Lindner
GENERAL MANAGER REGULATION
ETSA Utilities



ATTACHMENT 1: Australian Electricity Transmission and Distribution Decisions

Regulated entity	VIC DBs	Transend	Murraylink	Aurora	NSW DBs	ETSA	QLD DBs	Transgrid	Vic DBs	Directlink	WP	Aurora	Median
Service	Elec dist	Elec trans	Elec trans	Elec dist	Elec dist	Elec dist	Elec dist	Elec trans	Elec dist	Elec trans	Elect Dist	Elec Dist	
Regulator	ESC	ACCC	ACCC	OTTER	IPART	ESCOSA	QCA	ACCC	ESC	AER	ERA	OTTER	
Year of decision	2000	2003	2003	2003	2004	2005	2005	2005	2005	2006	2007	2007	
Equity beta	1.00	1.00	1.00	0.95	0.93	0.90	0.90	1.00	1.00	1.00	1.00	0.90	1.00
Gamma	0.50	0.50	0.50	0.50	0.39	0.50	0.50	0.50	0.50	0.50	0.45	0.50	0.50