Alinta
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

20 April 2007

Mr Mike Buckley
General Manager, Network Regulation North
Australian Energy Regulator
PO Box 1199
Dickson ACT 2602
By email: powerlinkreset@aer.gov.au

Dear Mike

Re: Cost of Capital - Bias in the Risk Free Rate

Thank you for the opportunity to comment on Powerlink's submission concerning issues emerging about the use of Commonwealth Government Securities (CGS) as a proxy for the risk free rate. The Powerlink submission and the attached report from NERA raises a very significant issue in relation to the estimation of the cost of capital for regulated businesses in Australia.

This issue has been one that Alinta has developed some familiarity with through its role as regulatory adviser to Multinet in the preparation of its Access Arrangement. Multinet has raised the same issues as Powerlink in its Access Arrangement proposal lodged on 30 March to the Essential Service Commission of Victoria (ESC) with the same report by NERA attached.

The report by NERA builds on views expressed by the Reserve Bank of Australia 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 CGS yields can no longer provide a sound estimate for the risk free rate - both real and nominal. This follows concerns put to regulators over recent years about the use of CGS to estimate the risk free rate, following decisions by UK regulators to adjust the yields on UK Government securities, because of their inadequacy as a proxy for the risk free rate in the UK.

NERA's estimates of the relative bias between indexed and nominal bonds of 20bp and the absolute bias of nominal bonds to the risk free rate of 42-44bp respectively make it clear that to simply continue to use CGS to estimate the risk free rate would result in a significant underestimate of the Powerlink's revenue cap. Alinta believes that the AER has no option than to give very serious consideration of this matter and may wish to collaborate with the ESC while it is considering this matter.

We also note that NERA are due to submit a supplementary report, which provides more robust analysis of the absolute bias on nominal CGS. This report can be expected to provide greater confidence about the level of the absolute bias.

Alinta is of the view that while this new research and evidence adds to the complexity of the estimation of the WACC, it is critical to sound estimates of the WACC, and that it will be necessary for this matter to be taken into account not only the present regulatory reviews, but in all regulatory reviews going forward.

In respect of Powerlink we believe that Powerlink has been very conservative in only seeking an adjustment for the relative bias (ie 20 bp), especially as the estimated total bias is up to 64 bp. While the 44bp absolute bias on nominal bonds would be offset in relation to debt through adjustment to debt spread estimates, a 64 bp adjustment to the cost of equity remains significant. If not accounted for it will mean that Powerlink's revenue cap does not fully compensate it for its cost of capital.

NERA has advised that its supplementary report will be available shortly. Alinta encourages the Commission to await the production of this report before making its Final Decision.

Should you wish further information please contact Chris Harvey, Manager Regulatory Development on 02 9270 4557.

Yours sincerely

Per Chris Harvey

Sandra Gamble
General Manager Regulatory