15 February 2013

For attention:

Craig Madden, Director, AER

Scott Sandals, Director, AER

By email: rateofreturn@aer.gov.au

Dear Craig and Scott

This letter is the EUAA’s submission to the Australian Energy Regulator on its Rate of Return Issues Paper. It also alludes to discussion at the first Rate of Return working group meeting earlier this month.

We commend the AER for the way that it is developing this work and the effort it is making to involve energy users in the development of its guidelines. We look forward to making a constructive contribution to this work in the hope that the eventual guideline is an effective response to the unsatisfactory Weighted Average Cost of Capital (WACC) outcomes that have been delivered so far.

At this early stage, we limit our response in this submission to just two issues

Our first comment is that we consider that the dichotomy that the AER is drawing between certainty and flexibility is a false dichotomy. Energy users have a preference for stable prices, just as we expect investors in network service providers have a preference for predictable returns. But regulatory determinations of the allowed rates of return that deviate substantially from the cost of capital are not acceptable to users, even if they are “certain”, stable or predictable.

The current arrangements for the determination of WACC places great importance on stability. But it has delivered returns that are a significant premium to the opportunity cost of capital. This is why the Energy Users Rule Change Committee proposed changes to the National Electricity Rules. Evidence of a substantial difference between allowed returns and cost is by far the most significant issue to consumers. A defence that although allowed returns are a premium to the cost of capital, they are at least predictable (or the methodology for their calculation is predictable) is no defence at all to energy users.

Our second comment, reiterates points we made at the first working group meeting. At that meeting we suggested that the AER should have regard to the level of the WACC determined by other economic regulators and regulators in other countries. There was some concern expressed by AER representatives that circumstances would differ amongst countries, for example that there would be different policy obligations and so on which would undermine comparisons. For this reason, it was questioned whether the AER’s resources would be well spent on developing (and having regard to) international WACC comparisons.

While we agree that differences in context are important, we respectfully disagree that this invalidates international comparison, or means that the AER should not have regard to such information in its WACC decisions.

Australia has open capital markets and investors in its network utilities will consider the allowed returns in Australia and compare them to those available for investment in similar firms in other countries. The allowed returns determined by regulators in other, comparable, countries is therefore absolutely relevant in AER decisions.

Comparable countries with similar regulatory frameworks and network performance standards and where WACC data is readily available includes Canada, the United States, Great Britain and New Zealand. Several other non-anglophone countries particularly those in continental Europe would also be relevant in such a comparative analysis, although language barriers may make data collection in these other countries more difficult.

There is already a precedent for a wider, international perspective of the cost of capital. For example in its advice in the development of the State of Regulatory Intent, AER staff had regard to international evidence on equity betas. While this is valuable we would encourage the AER to go further and have regard the eventual outcome (the allowed WACC) and not just the individual WACC parameters.

In the first rate of return workshop we were asked to provide some practical advice on how this could be taken forward. As an example of the sorts of comparisons that we suggest might be useful, the attachment to this letter is a chart that we have developed of a comparable measure of WACC (the Vanilla Pre-tax WACC less the risk free rate) that has been determined in all electricity and gas network service provider regulatory determines by the AER, ACCC and all jurisdictional regulators in the states covered by the National Electricity Market. This shows that the AER has consistently set a higher allowed rate of return than the ACCC or jurisdictional regulators. It is evidence such as this, extended to an international comparison that we think the AER should have regard to in setting WACC in all future regulatory decisions.

Finally, as a further example of international comparison, we draw attention to Mountain and Littlechild (2011)[[1]](#footnote-1) which compared the real vanilla WACC in regulatory decisions by IPART, the AER and by Ofgem in Britain, by way of explaining part of the reason for the large (and growing) gap between the charges for distribution services in Britain and in New South Wales.

We propose that development of such international comparisons should be an essential feature of all the AER’s WACC decisions, and hence that this approach would be described in its WACC guideline. We look forward to active discussion of this at the forthcoming workshop in late February.

Yours sincerely

Brian Green

**Chairman**

**Attachment: A comparison of nominal vanilla WACC less risk free rate determined by the AER, jurisdictional regulators and ACCC**



1. Mountain, B., Littlechild, S.C, 2010. *Comparing electricity distribution network revenues and costs in New South Wales, Great Britain and Victoria*. Energy Policy, Issue 38. [↑](#footnote-ref-1)