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Mr Sebastian Roberts
General Manager
Regulatory Affairs - Electricity
Australian Competition and Consumer Commission
Level 35, The Tower
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By email: sebastian.roberts@accc.gov.au

Dear Sebastian,

ElectraNet Response to Reports by ECCSA

ElectraNet welcomes the opportunity to respond to the submission made by the Electricity Consumers Coalition of South Australia (ECCSA)[1]. The ECCSA submission raises a number of issues that suggest that regulatory rates of return are too high.

However, several of the contentions raised in this submission are seriously flawed, resting on inaccurate data with incorrectly applied methodologies. Consequently, the ECCSA submission draws inappropriate inferences from the analysis presented. We note that these same errors were present in some of the presentations and discussions on the cost of capital at the ACCC's regulatory principles workshop held on 2 April 2004.

The purpose of this submission is to draw these issues to the Commission's attention. The submission begins by highlighting a fundamental flaw with the ECCSA report – namely its reliance on accounting information as the sole determinant of market valuations. Following explanation of this flaw, this submission broadly follows the outline of the ECCSA submission.

Accounting information and valuation

The central theme throughout the ECCSA submissions is that movements in the value of companies through time should be completely explained by accounting information. In other words, the data to support the ECCSA analysis, and from which inferences as to the sufficiency or otherwise of regulatory rates of return are drawn, is based on EBIT data. However, accounting data such as EBIT, whilst relevant to valuations, is but one of the information sources that market participants rely on to inform valuation decisions.

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[1] "Further Capital Markets Evidence in relation to the Market Risk Premium and Equity Beta Values", December 2003, a report prepared for the ECCSA and late submission to the ACCC review of draft regulatory principles. This report has been supplemented by another entitled "Response to observations critical of the Research Paper".

Accounting is about the recording and presenting of historic information in a manner that is useful for decision makers. In so doing, accounting information applies standardised principles such as accrual accounting concepts and the doctrine of conservatism. However, accounting data is limited in terms of what it says about the future. The past may or may not be indicative of the future.

In contrast, information relied on for valuation decisions (including the cost of capital) is fundamentally about the future rather than the past, and it is only in this context that accounting information is relevant (i.e. to the extent that it provides an indication of the future). Valuation is very much therefore a forward looking concept based on expectations about the quantification and distribution of future cash flows and risks.

For example, accounting data says little about how a company is positioned to respond to the competitive threats that are likely to emerge over time, about trends in a company's market share, or the quality of its strategies to grow revenue. Yet these are issues that determine how companies are valued because they affect *expectations* about *future earnings*. In this light, it is therefore not surprising that empirical studies suggest that accounting data contributes to ONLY around one half of the movement in share prices over time. [2]

Accordingly, market values and expected cash flows may or may not be correlated with book values and historic accounting information. However, the report assumes that a very strong relationship exists between accounting numbers and market valuations (and in turn WACC inputs). This fundamental flaw leads ECCSA to make a number of incorrect assertions that are highlighted in the following sections.

Moreover, historical accounting profits are not indicative of economic profits for a range of reasons – not least the divergence between accounting and economic depreciation. It is precisely for these reasons finance professionals use market returns (i.e., dividends plus capital gains) to measure historical returns to investors. Moreover, it is this methodology on which the current estimates of the MRP are based.

The ECCSA submission's reliance on accounting data flies in the face of well-accepted finance theory and practice. Before any weight should be given to its findings ECCSA should show why their approach is correct and the academic finance practitioners are misguided.

International comparisons of WACC

The ECCSA report compares the results of several studies comparing regulator's decisions on WACC in an international context. In using these reports, the ECCSA does not mention the most comprehensive review of international WACC decisions performed by NECG[3]. ElectraNet notes that this more recent and detailed report found that WACC decisions by Australian regulators are anything but generous when compared to their international counterparts, once adjustments are made for the various country specific factors.

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[2] R. Ball and P.Brown, "An Empirical Evaluation of Accounting Income Numbers", Journal of Accounting Research, Vol. 6, No. 2 (Autumn, 1968) pp. 159-78

[3] "International comparison of WACC decisions", Submission to the Productivity Commission Review of the Gas Access Regime from the Network Economics Consulting Group, September 2003.

The specific deficiencies of the reports cited in the ECCSA report are set out below.

Pareto Associates

The report by Pareto Associates contains a number of fundamental errors, including:

- failure to adjust for the risk free rate of the various jurisdictions;
- failure to take account of gearing differences;
- failure to adjust for the differences in the way that regulator's quote the WACC for regulated entities. For example, the Pareto report compared the "vanilla WACC" (as used by the ACCC) with the post-tax nominal WACC (as applied by OFWAT) without correcting for the fact that the post-tax nominal WACC adjusts the cost of debt for taxation exaggerating the differences between regulatory rates of return. The failure to adjust for this factor is analogous to comparing a profit before tax with profit after tax – whilst they are reconcilable, they represent different figures that cannot be directly compared with one another without adjustment.; and
- the assumption that the market risk premium (MRP) is the same in all jurisdictions. The MRP varies between countries with differences in market composition, taxation, country risk and so on. As the UK and the US economies are more diversified than the Australian economy, it is reasonable to expect that their MRP will be lower than Australia's MRP.

ACG

The ACG report suggested that equity betas allowed by Australian regulatory bodies are too high. However, the ACG analysis did not consider the limitations of the data that underpinned its analysis.

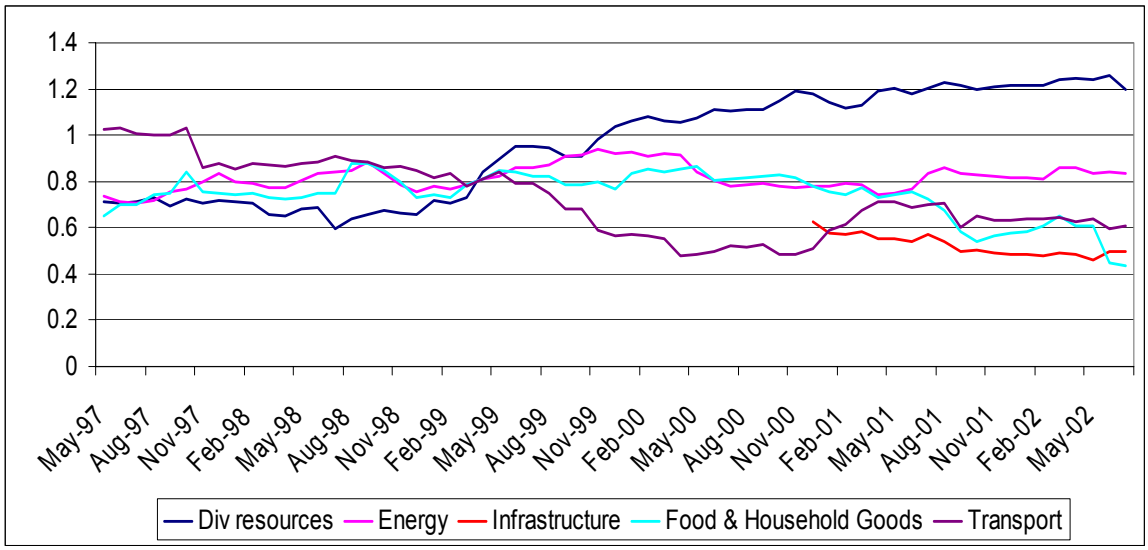
Equity betas often exhibit high standard errors and can be misleading on account of the statistical properties of betas. For example, a beta with a high standard error means that it cannot be said to be statistically significant (i.e. different from zero) and hence is unreliable for the purposes of statistical inference.

In addition, a company for whom the covariance of returns with the market as a whole presents a correlation coefficient (R^2 value) close to zero means that the stock is likely to exhibit a statistically insignificant beta – even though that beta measure itself may be relatively high.

Consequently, it is usual to subject beta estimates to diagnostic tests (i.e. t statistic and R^2 tests) to determine their statistical validity. However, the ACG analysis did not subject the betas comprising its sample to these diagnostic tests to reveal these deficiencies. Consequently, the conclusions that were reached are highly suspect.

Moreover, the ACG analysis is subject to selection biases, both in terms of the range of firms selected as well as the time period over which the analysis was conducted. As betas are time varying, a beta calculated in one period may not be representative in a different period. A consequence of this is that a 1998 beta is not applicable to a decision being made today. This is illustrated in **Figure 1** below.

Figure 1: Beta volatility over time



Source: Bloomberg

Mercer Investment Consulting

The Mercer Investment Consulting study surveyed brokers. ElectraNet considers considerable caution is required in relation to the views of brokers. First, brokers are highly unlikely to be knowledgeable with respect to the theoretical and empirical research on the issue. Secondly, broker's forward-looking assessments are likely to be strongly correlated with the very recent past and as a consequence have no predictive power. Moreover, the Mercer study paid no regard whatsoever to the biases likely to be exhibited by participants in its sample.

NERA

The NERA report answered very specific questions put to them by the ACCC. They were not asked, and did not attempt to, make adjustments for different levels of risk and different levels of domestic interests rates across the jurisdictions surveyed. NERA noted that while such an investigation of country specific risks was warranted it was outside the scope of its report – which was fundamentally a data gathering exercise. We understand that NERA has counselled against interpreting its report as comparing actual risk adjusted (as opposed to reported) rates of return.

The evidence cited by ECCSA therefore does not support the proposition that rates of return set by regulators in other countries are high compared to those allowed by Australian regulatory bodies.

Market risk premium

Reliance on short-term estimates of the MRP

The ECCSA suggests that reliance on a 100-year average of the market risk premium imports too long a data series and that shorter data series should be relied upon. ElectraNet

submits that the ECCSA is wrong to assert, "the recent past does provide a better and more realistic indication as to what may happen in the short term". This is definitely not the case, especially for parameters such as the MRP that is time varying and is highly volatile in the short term.

For example, consider the prevailing economic conditions. We are currently experiencing historically low inflation, encountered 2 years of negative market returns (2000 and 2001) followed by a property boom, oil prices are at the highest levels since the Gulf War, there are currently several wars around the world and we are exposed to the instability posed by continuous terrorist threats. This does not reflect anything like the conditions that have prevailed in the past or are necessarily likely to prevail in the future.

ElectraNet submits that the statements attributed to Dr Davis need to be considered in this light. While it may be true that in the short run the supply of funds to the market in Australia may have increased, such a development represents just one factor that is likely to only exert a short-term impact on the MRP (if at all).

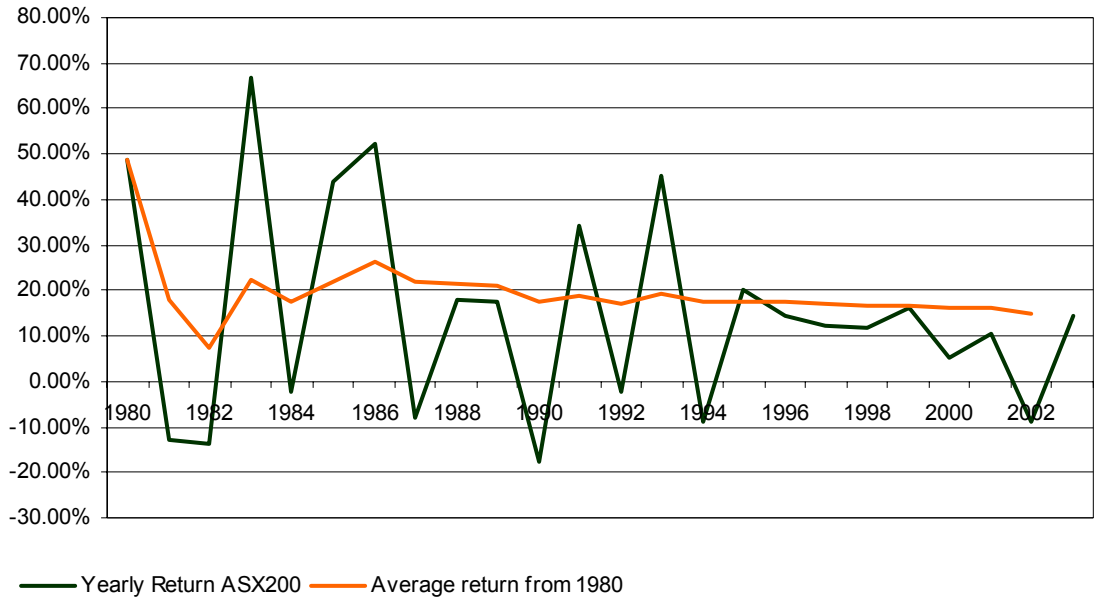
There are many reasons why this is the case. Any change in Australian conditions must be considered in the context of Australia representing just 1% of global capital markets. Moreover, we have seen many factors exert a short-term influence on the MRP – witness the volatility in realised returns over time. Indeed, the last century has seen a procession of events that could reasonably be expected to exert some influence on the MRP in the short term – yet this is precisely why it is important to adopt a long term average for the MRP.

Hence, the whole reason for taking a long-term average is that doing so incorporates the collective market wisdom over a long period of time and in turn is informed by a wide variety of market conditions. In the long term all of these factors tend to balance out. This is the very reason why it is necessary to use a long term calculation and not a short term calculation.

A cursory examination of the data contained in the ECCSA submission highlights this fact in the sense of the standard errors of the estimates contained in table 5.3 of the ECCSA submission (page 20). For the period 1970-2001 the standard error (4.31%) is materially higher than the mean (3.37%) – suggesting that considerable caution must accompany the interpretation of these results. A 95% confidence interval suggests that the MRP falls within the range of -5.25% and 12% - a range of over 17% clearly highlighting the shorter term volatility. In contrast, a 100 year average would fall within a range of around 5%.

Figure 2 illustrates this volatility over time by comparing the annual return from the ASX 200 with the average return over the period between the year in question and 1980. Figure 2 shows that the average return between 1980 and 2002 was 14.91%. On average, a better indication for a given year, such as 2003 (14.6%), is not 2002 (-8.8%) but the longer term average (based on this sample, this longer term average equals 14.91%).

Figure 2 Comparison of annual and average returns 1980-2003



Source: Bloomberg

It is also noted that this 20-year average is a higher average annual return than the corresponding 30-year period cited in the ECCSA (approx 4.1% or around 4.8% when allowance is made for imputation credits if a gamma of 0.50 is assumed). ElectraNet does not suggest that the 20-year average should be adopted instead of the 30-year average – instead, it merely shows the merit in longer term assessments of the MRP. In the same way, ElectraNet suggests that 100-year averages of the MRP should be given due consideration by regulatory bodies and that very short term averages should be avoided.

Finally, it must be remembered that the role of the regulatory rate of return is to provide a signal as to the remuneration of new investment. In the case of infrastructure industries this invariably relates to long term investment. Reliance upon very short-term fluctuations in the MRP therefore provides no basis to inform the cost of capital for long-term investment decisions.

The MRP is a volatile measure with a high standard deviation. Consequently, the only way in which this data can be applied is to adopt a long term average of the MRP over time. Consequently, when it is remembered that the long term average of the MRP in Australia is between 6-8%, it can be seen that the ECCSA report provides no basis to reduce the MRP below 6% .

Assessed returns of the market

ECCSA goes on to draw data from IBISWorld to support its arguments. This data set includes private firms that are not listed and hence does not correspond with indices such as the ASX 200. In addition, this dataset ranks firm's size based on revenue rather than by market capitalisation and hence cannot be directly compared with stock market returns.

Moreover, the comparison is undertaken on the basis of the EBIT/assets ratios of the firms forming the sample. EBIT/assets ratios are historic accounting numbers that do not

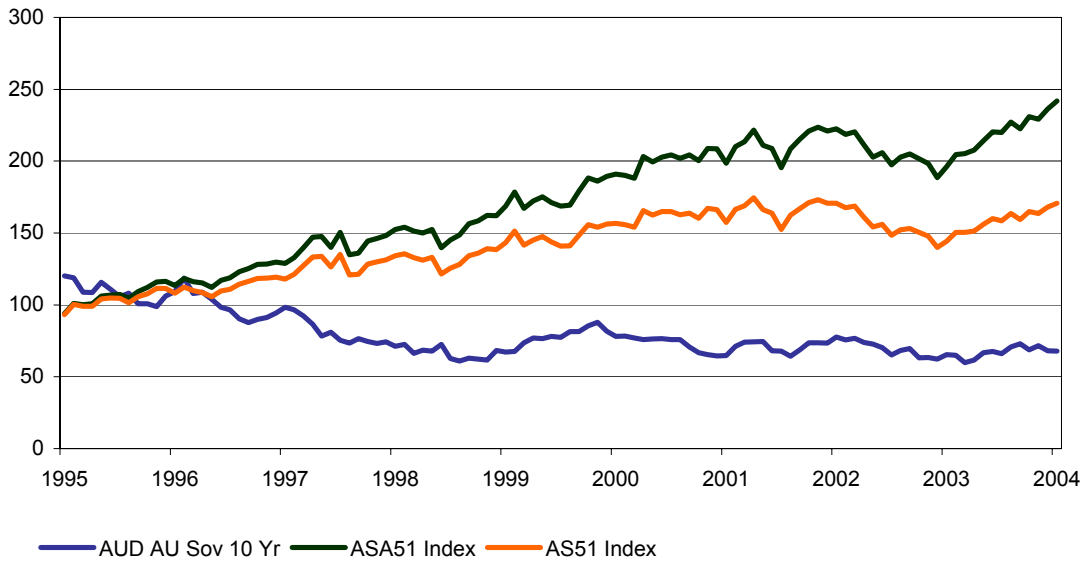
necessarily equate to market values, do not incorporate cash flows and do not capture nor reflect growth potential. Again, empirical studies suggest that accounting data contributes to ONLY around one half of the movement in share prices over time.

The submission goes on to assert that (page 18):

> *This analysis shows that 10 year government bonds were a better investment over the past decade than investing in businesses and that "real" pre tax returns earned in the competitive market in the period 1989-2000 averaged perhaps 4%, (which should be compared to the "real" pre tax WACC's awarded by regulators of 6-8%)*

However, in addition to the errors in this approach outlined above, this analysis fails to consider the impact of increases in the value of the assets over time. To measure the success or otherwise of an investment over time, regard should be had to the Accumulation Index rather than the EBIT/Assets ratio. Figure 3 below compares investing in 10-year bonds compared with investing in the ASX200 and the ASX200 Accumulation index (the latter index assumes that dividends are reinvested in the stock but does not capture imputation effects).

Figure 3 Comparison of market returns and 10-year bonds 1995-2003



Source: Bloomberg

Clearly both indices show a higher rate of return than government bonds over the last 10 years (the fall in the total return index for Government bonds reflects both the yield and the change in the capital value of the bonds). However, even then, one cannot simply compare these returns. The real measure of what constitutes "a better investment" involves having regard to not only returns but also to risk.

Similarly, the assessment of the MRP over time based on accounting data using IBISWorld data is flawed. It assumes that investors buy assets at historic cost. However, investments are assessed on the basis of expected returns over time – not on historical accounting information.

The ECCSA data therefore ignores the fact that investors buy shares in companies, not assets based on historical costs. Shareholders receive a dividend and the value of the share may appreciate or depreciate over time (as reflected in the accumulation index) as investors reassess the future earning potential of the firm. Again, it must be remembered that empirical evidence suggests that accounting information (such as EBIT) explains ONLY about one half of the variation in share prices over time.

Accordingly, no meaningful interpretations can be taken from ECCSA's analysis of changes in the MRP over time.

The ECCSA incorrectly assesses the MRP over the relevant period and incorrectly asserts that long-term bonds provided a better investment than assets in competitive industries.

Equity betas

The submission repeatedly makes reference to an equity beta of 1.0 being too high due to the fact that regulated businesses are low risk assets. The report states (at page 23):

> *Thus, to assign equity beta of unity to a specific enterprise is to assume that it has the same risk as all enterprises in the market taken as a whole.*

In so doing, the report fails to recognise that an equity beta reflects two distinct risks:

- the risk related to an asset (asset beta); and
- the risk associated with the entity's capital structure.

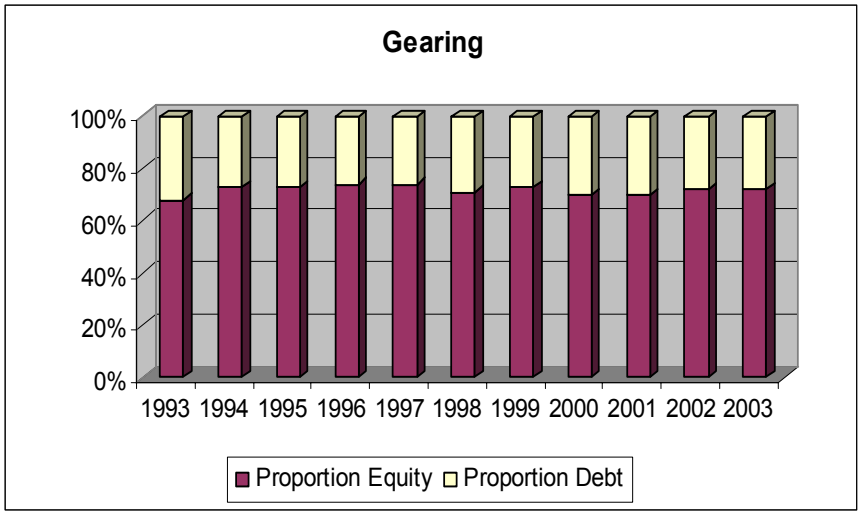
In responding to these issues, ElectraNet considers first, issues with gearing and then considers the systematic risk.

Gearing levels

The ECCSA report confuses asset betas and equity betas. When comparing beta estimates, it is necessary to remove the effects of gearing and compare the systematic risk of the assets alone (known as asset betas). The ECCSA report makes repeated reference to the equity beta of 1 but in so doing ignores the impact of gearing. Indeed, the average asset beta of the market as a whole is closer to 0.7 (value weighted) than the 0.4 adopted for regulatory decisions.

Compounding this error is the fact that the ECCSA report makes repeated reference to the levels of gearing of Australian companies being in the order to 77%. This is simply wrong. Whilst ElectraNet cannot comment on the sample used by the ECCSA, an analysis of the gearing levels of the listed companies in Australia over the last decade shows a high degree of consistency in gearing levels being approximately 30% (refer to Figure 4).

Figure 4 Gearing levels of Australian listed companies 1993-2003



Source: Bloomberg

The errors made by ECCSA in respect of gearing levels are seriously compounded by similar errors in respect of the assessment of systematic risk.

Systematic risk (beta) and performance

The report goes on to state that (at pages 23 and 25):

> Equity beta provides the measure by which the returns of a specific company or industry will vary above or below the average equity return of all industries.
>
> This treatment thereby provides electricity transport businesses with greater certainty of revenue, implying a lower equity beta then would apply for gas transport businesses.

However, beta is not a measure of the certainty of return. Rather, beta is a measure of the systematic risk of an investment – it is that component of risk that cannot be diversified away. It is a measure of covariance not certainty. A simple example will illustrate this distinction. A term deposit with a major bank has certainty of return but the return will be unrelated to the market and hence have a low beta. Another investment with a great deal of uncertainty in terms of return, but also unrelated with the market would also have a low beta. Betas do not measure degrees of certainty of return.

Over time, it is true that there is likely to be a relationship between movements in the market and movements in a particular stock, but this is quite different to a measure of the certainty of a return. A measure of a beta does not in any way reflect the certainty of a return.

Similarly, ECCSA argues that the out-performance of the index indicates that the allowed equity betas for regulated firms are too high indicating (at page 25) that:

> *The stability and outperformance of the Utilities index compared to the benchmark ASX 200 supports the contention that a value of unity for regulated businesses is too high.*

However, there may or may not be a relationship between the performance of a stock and the beta of that stock. Performance reflects actual return while the CAPM beta measures the return expected for the systematic risk of the firm. Actual return can be (and is mostly) different from expected return. The performance relates to returns from dividends and capital growth whereas beta is simply a measure of systematic risk. Beta measures the *sensitivity* of the returns of a stock relative to the market as a whole. If a particular stock is relatively insensitive (highly sensitive) to the market as a whole then it will have a low (high) beta regardless of performance. Consequently, the arguments that high returns for utilities based on the IBISWorld database justifying lower equity betas are flawed.

Moreover, reliance on accounting data of the type used by ECCSA relies heavily on the asset values used in accounts. Companies (especially private companies) have considerable discretion as to the asset values contained in their accounting records. That is why the only appropriate basis upon which one can meaningfully assess performance is to use market data and measure equity return as dividend yield and capital growth.

Indeed, capital growth in the ASX 200 Index between 1995 and 2003 averaged around 8%. The impact of the growth is ignored in the ECCSA analysis. Retained earnings are NOT a valid proxy for expected capital growth. What makes this omission so significant is that regulated businesses (being high yielding assets) rarely experience substantial growth, even in nominal terms. Indeed, the impact of straight line depreciation can mean that capital values of regulated infrastructure stock can actually decline over time (even in nominal terms).

Finally, on issues such as the appropriate beta to be applied to transmission companies, having regard to, amongst other things, the high standard errors of beta estimates and the volatility of beta estimates over time, ElectraNet refers to its previous submissions to the Commission.

The ECCSA misconceives the concept of beta and the factors that affect it such as certainty of return or the relationship between beta and ex post performance. The contentions made by ECCSA are therefore invalid.

Implications of DORC valuations

ECCSA misunderstands the nature of accounting for increases in asset values where it states (at page 27) that:

> *Annual reporting by businesses of their financial performance follows strict accounting rules. In particular, assets are normally valued at historic costs and if an asset is revalued then the profit or loss resulting from the revaluation is included in the profit and loss statement, increasing or decreasing the declared corporate profitability.*

This statement is incorrect. Reporting unrealised profits in the profit and loss account is not permitted under the Accounting Standard relating to the Revaluation of Non-Current Assets. AASB 1041 requires that firms report the increment for revalued assets in the asset

revaluation account and not in the profit and loss account. Any increase in the asset value for accounting purposes does not affect reported profit.

The ECCSA goes on to criticise DORC based valuations on the basis of subjectivity and instead suggests that accounting data (historic cost) presents a more realistic basis for the valuation of assets based on it providing an auditable derivation process for the value. However, just because a process is auditable does not mean it is meaningful or in any way relevant. The key issue is that accounting data does not report market values.

There is a huge body of empirical evidence[4] that supports the hypothesis that accounting changes that simply affect reported profits and do not have a cash flow effect DO NOT affect share prices and market values. These types of accounting changes are commonly called "cosmetic" as they do not fundamentally affect the profit or cash flow of a company. Asset revaluations are a common example of a cosmetic accounting change.

A new entrant to an industry will consider the investment of entering that market – in terms of the current values (ie replacement costs) rather than the historical values in a competitor's balance sheet. This is especially the case for regulated infrastructure industries which involve long lived assets, highlighting the irrelevance of historical cost assessments.

Moreover, the ECCSA submission appears to assume that historical cost is the only way in which assets are valued. However, asset revaluations occur continuously where firms perceive benefits from doing so. Indeed, accounting standard AASB 1041 explicitly recognises that firms may revalue assets on the basis of their assessed market values.

In turn, the irrelevance of the accounting data relied upon by the ECCSA, translates into the incorrect conclusions being drawn as to the MRP. The MRP is not calculated by reference to the difference between the (accounting) return on equity and the risk free rate. A firm's return on equity is not applicable as it is an accounting number based on accounting data that may or may not reflect market values. It will not reflect the market's assessment of the valuation of the firm at any time nor will it capture expected growth. RoE is therefore not a valid proxy to use in the calculation of the MRP.

The Supplementary Report produced by ECCSA goes on to assert that:

> *Regulatory practice permits the asset value to increase (using replacement cost for asset value does this automatically) and then applies an MRP derived from the inclusion of asset revaluation. Implicitly this approach permits a double counting of that element of share growth, which results from asset valuation.*

This statement is simply wrong and shows a basic misunderstanding of regulatory pricing models. Any forecast increase in the regulatory asset value considered over the course of the regulatory period is taken into account in setting prices. There is no double counting as is asserted by ECCSA.

Finally, ElectraNet reiterates that beta measures are volatile, even as measured over industry sectors. ElectraNet refers to its previous submissions to the Commission on this issue.

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[4] Positive Accounting Theory, R. Watts and J. Zimmerman, Prentice-Hall 1986 contains detailed surveys of empirical studies about share price reaction to accounting choice.

There is no basis for applying historical cost valuations of assets for regulatory purposes. Reliance upon accounting data from competitive sectors of the economy will generally provide a poor basis for the assessment of performance or the drawing of inferences as to the sufficiency or otherwise of rates of return. The statement that regulatory practice double counts changes in asset values is wrong.

Gearing

An assessment of gearing levels of Australian listed companies was contained in Figure 4. The ECCSA submission goes on to argue that (at page 30):

> *The CAPM formula assumes that all of the funds used by an enterprise are either interest bearing debt or equity.*

However, the CAPM does not consider all funds to be interest bearing or equity as is asserted by the ECCSA. Non-interest bearing debt is adjusted for in working capital. It affects the quantity of interest bearing debt that an organisation is assumed to borrow.

The ECCSA goes on to argue that the 60% gearing assumed by regulators is too low. However, the gearing for the firms in the Utilities sample varies from 31% to 72%. Clearly, the current regulatory benchmark is therefore at the upper end of this range.

Moreover, reliance upon the gearing of wholly owned subsidiaries is misguided. The capital structure of a particular company in a group will be affected by numerous factors, including the tax efficiency of the gearing of different subsidiaries operating in different tax environments. Similarly, gearing levels in government business enterprises are driven in part by budgetary considerations (noting that such companies enjoy the support of an implicit government guarantee in any event).

The ECCSA's assertion of gearing levels of Australian companies being in the order of 77% is incorrect. The ECCSA submission provides no basis for increasing the level of gearing benchmark from the 60% that has been adopted by the ACCC. Indeed, the ACCC benchmark assumes a level of gearing which is approximately twice the average gearing of listed companies in Australia.

Comparison with the property market

The ECCSA asserts that there is a close correlation of its sample with the returns of the ASX 200 over the relevant sample period. As ElectraNet does not have access to the sample used by the ECCSA it is not possible to assess whether or not this is the case.

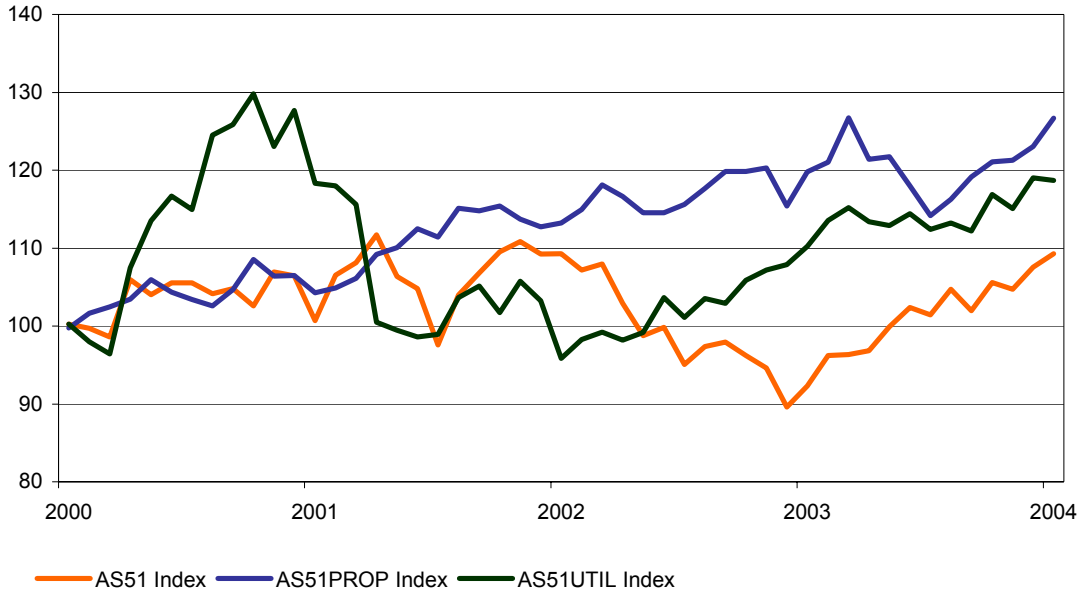
However, it is noted that any two samples using a common starting point will almost always exhibit a correlation (as they both have a common base), irrespective of whether or not one exists in a statistical sense. It is for this reason that correlations are normally assessed on the basis of *returns* (for an index). It therefore cannot be assumed that the ECCSA dataset can be used as a surrogate for the ASX200.

The ECCSA then uses its sample as a basis for making comparisons with returns in the property sector. Recall that performance is a very different attribute to betas – the latter reflects systematic risk whereas the former does not. Equity betas cannot be inferred by

comparing returns over time – rather a regression analysis is required that measures the covariance of returns with the market.

In terms of drawing comparisons between the property sector and the utilities sector, the first issue is to properly examine whether in fact a statistically valid relationship exists. Figure 5 shows the performance between sectors since the start of the index (rather than the date selected by the ECCSA).

Figure 5: Performance of Industry Sectors 2000-2003



Source: Bloomberg

Figure 5 illustrates that there is little relationship between Utilities and Property. The correlation coefficient between Utilities and Property is only 0.14 (once account is taken of the common starting point of the two indices). Accordingly, the returns of the two indices suggest that no meaningful relationship in fact exists between the sectors. Consequently, it is difficult to see what can be gained from inferring an assessment of the systematic risk between the sectors.

Investment levels

ECCSA in its Supplementary Submission asserts that there can be no concern with regulatory rates of return on account of investment in electricity networks continuing unabated. However, this statement overlooks the reality that the vast majority of network investment occurs in response to license requirements to maintain reliability standards. This is not discretionary investment.

Accordingly, the best source of information about the impact of regulatory rates of return on investment arises in instances where no such license conditions exist. One example is the privatised gas transmission industry. Here, all significant (unsubsidised) investment that has occurred since regulation began (amounting to well over $2 billion) has been directed towards pipeline infrastructure that is unregulated. This is hardly an outcome one would expect if regulatory rates of return were in fact a sufficient reward for new investment.

Statistics about levels of investment post regulation are misleading due to the existence of license conditions requiring investment. In sectors unaffected by such conditions, investment levels in regulated infrastructure have been extremely low.

Five versus ten year bond rates

ElectraNet has commented extensively on this issue in the past. ElectraNet understands that this issue has recently been definitively resolved by the Australian Competition Tribunal's recent decision on GasNet[5] and in the ACCC's draft revenue cap decision for TransGrid.

The ECCSA provides no evidence to support applying the 5-year bond rate as the proxy for the risk free rate.

Regulatory circularity

ElectraNet does see benefit in a stable regulatory environment, as long as that environment provides sufficient returns to businesses to encourage new investment. Constant change to regulatory parameters creates a new risk that was overlooked in the ECCSA analysis – namely that of regulatory risk.

In this regard, the "circuit breaker" of overseas returns suggested by the ECCSA has some merit but for very different reasons to those suggested by ECCSA. This is because more detailed analysis has revealed that (with the exception of the UK) returns provided by overseas regulators are in general considerably higher than those provided by Australian regulatory bodies.

ElectraNet believes that there is a case for revisiting rates of return allowed by Australian regulators. However, this is due to the fact that empirical evidence suggests that Australian regulated rates of return are low by international standards.

For the reasons outlined in this letter, ElectraNet believes that the analysis contained in the report produced by the ECCSA is seriously flawed, resting on inaccurate data with incorrectly applied methodologies. Consequently, the ECCSA submission draws inappropriate inferences from the analysis presented.

ElectraNet would be happy to elaborate on this submission at your convenience.

Yours sincerely,

Rainer Korte
NEM DEVELOPMENT AND REGULATION MANAGER

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5 Australian Competition Tribunal, Application by GasNet Australia (Operations) Pty Ltd [2003] ACompT 6.