

20 November 2002

John Martin
Commissioner
Australian Competition and Consumer Commission
PO Box 1199
Dickson ACT 2602

By email: john.martin@accc.gov.au

Dear John,

ElectraNet SA Final Revenue Cap Decision – Risk Free Rate

The Commission's GasNet final decision released yesterday goes to some lengths to explain why the Commission has determined the risk free rate from yields to maturity on Government bonds with a term equal to the term of the regulatory period (usually five years). The following quotes are taken from p85-86 of the final decision.

"In themselves, arguments such as those put forward by GasNet, that the Commission should adopt the 10 year bond rate as the benchmark to be consistent with other regulatory authorities, carry little weight. The Commission is of the view that the interests of no party to the access arrangement can claim to be compromised unreasonably if the best estimate of the risk free rate for the circumstances is applied. This is why the Commission sought expert advice from Lally to confirm that the normal approach adopted by the Commission in establishing the risk free rate was indeed theoretically correct and appropriate in practice given the nature of the financial framework being used. Lally's analysis was comprehensive and confirmed that the risk free rate is best determined from yields to maturity on Government bonds with a term equal to the term of the regulatory period (which is usually five years but may be for a different period)".

"Lally's paper is available on the Commission's website for academic scrutiny and stands on the basis of its own logical integrity. While the Commission has taken into consideration the arguments provided by GasNet and its consultant, it does not consider it appropriate or necessary to provide a line-by-line commentary to demonstrate that they do not undermine the basic conclusion of the Lally report... The finding of Lally's analysis does not require a change from the position the Commission has always adopted. Perhaps, rather than rejecting the Lally result, other regulators have simply chosen to maintain consistency with their own prior decisions. One thing is clear, and that is that the use of a bond term or the risk free rate equal to the regulatory period subject to review is a clearly established benchmark used by the Commission and should not be an unexpected aspect of this decision".

We note that the Commission appears to have relied almost exclusively on the Lally paper in support of its position on the risk free rate in its most recent regulatory decisions.

As you are aware, ElectraNet asked the Network Economics Consulting Group (NECG) to critique the Lally paper and a presentation of NECG's findings was made at the ACCC's SPI PowerNet public forum last week (comments attached). NECG found that Lally's conclusions hold only under extreme assumptions that clearly do not apply in regulatory practice in Australia (including the regulatory regime adopted by the ACCC).

Therefore, while Lally's analysis may confirm that the approach adopted by the Commission is theoretically correct, it is definitely NOT correct or appropriate to apply in practice.

Hence, the Lally paper provides no justification for moving away from the standard commercial practice of matching (to the extent possible) the term of the risk free rate with the longer lives of the assets.

There appear to be no compelling reasons for the Commission to maintain its isolated position on the risk free rate (we note that contrary to what the GasNet decision says, the Commission has NOT always adopted its current position on this issue).

We reiterate our request of last week that proper consideration be given to the NECG critique of the Lally paper in the final revenue cap decision for ElectraNet SA and that the ACCC adopt the 10-year bond to determine the risk free rate in this final decision.

Please don't hesitate to call me on 08 8404 7983 if you would like to clarify or discuss any aspect of this letter.

Yours sincerely,

[Sgd] Rainer Korte

Rainer Korte
MANAGER REGULATION