

2 February 2009



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Submission on Explanatory Statement and Proposed Statements of Regulatory Intent on the revised Weighted Average Cost of Capital

Dear Chris,

Jemena Limited (Jemena) welcomes the opportunity to make this submission to the Australian Energy Regulator (AER) on the Explanatory Statement and Proposed Statements of Regulatory Intent on the revised Weighted Average Cost of Capital (WACC). In this submission, we refer to the statements as the WACC Review Draft Decision, or Draft Decision.

Introduction

The AER's Draft Decision impacts on a number of the regulated assets owned (or partially owned) by Jemena:

- Jemena Electricity Networks (JEN)—an electricity distribution business in Victoria with over 300,000 customers. The final decision on the WACC Review will apply directly to JEN when the AER resets Victorian distribution tariffs for the 2011-2015 regulatory period.
- Jemena Gas Network (JGN)—a gas distributor in NSW with over 1 million customers. JGN is in the process of preparing a revised access arrangement to be submitted to the AER by 1 July 2009. The AER has, in its Draft Access Arrangement Guideline, stated that gas service providers should refer to AER regulatory decisions on the cost of capital. Therefore, Jemena understands that the AER's final decision on the WACC Review may have an impact on JGN's gas access arrangement.
- Actew AGL Distribution Partnership (Actew AGL – a public-private joint venture of which Jemena and the ACT Government each own 50 percent)—an electricity and gas distributor in ACT with over 150,000 electricity customers and over 100,000 gas customers. While, for the 2009-2014 period, Actew AGL's electricity business will be operating under transitional

arrangements, the final decisions on the WACC Review will have a long-term precedent effect on ActewAGL's electricity and gas network businesses.

Jemena's Comments

Jemena has contributed to and fully supports the submission made by the Joint Industry Associations (JIA).

Consistent with the JIA submission, Jemena would like to highlight the following concerns with the AER's Draft Decision:

- In Jemena's view, in making the Draft Decision, the AER has not had due regard to the important considerations listed below:
 - the National Electricity Objective—in particular, promoting efficient investment
 - the Revenue and Pricing Principles—in particular, providing a regulated network service provider with a reasonable opportunity to recover at least the efficient costs the operator incurs; and
 - the specific Weighted Average Cost of Capital provisions in the National Electricity Rules—in particular, the requirement for the rate of return to be the cost of capital as measured by the return required by investors in a commercial enterprise with a similar nature and degree of non-diversifiable risk.
- The Draft Decision puts forward the AER's preferred values for parameters to be used in the Capital Asset Pricing Model (CAPM) to estimate the allowable return for electricity distributors. In Jemena's view, the AER's preferred parameters lead to an estimate of the Weighted Average Cost of Capital (WACC) that is below the true cost of capital for electricity distributors in the prevailing market conditions. The estimate is therefore below the return required by investors in a commercial enterprise of a similar nature.
- The AER's Draft Decision proposes to adopt values for individual WACC parameters that are different to the values that have previously been adopted—in particular, the equity Beta, the term of the risk-free rate proxy, the benchmark debt rating and the Gamma. In making any changes to previously adopted parameters, the AER must have regard to the need for persuasive evidence that shows a change in a parameter value is warranted. In Jemena's view, the AER:
 - has not put forward in the Draft Decision persuasive evidence to warrant the parameter changes proposed, and
 - has misunderstood and, as a result, has not given sufficient weight to the persuasive evidence test.
- Jemena, therefore, supports the JIA position that the appropriate key parameters to be used are:
 - an equity Beta of 1

- a 10-year Commonwealth Government Security as a proxy for the risk-free rate
 - a BBB+ benchmark credit rating, and
 - a 60 percent benchmark gearing.
- Jemena would also like to draw the AER's attention to the strong evidence put forward by the JIA that the following parameters should differ from their previously adopted values:
 - Gamma, where a decrease is warranted from a value of 0.5, to a value of between 0.0 and 0.2, and
 - Market Risk Premium, where an increase is warranted from 6 percent to 7 percent.
- On the specific issues of the term of the risk free rate proxy and the appropriate benchmark credit rating, Jemena's Head of Treasury, Buck Sim, has made a statement, which is attached to the JIA submission. In summary Mr Sim's statement:
 - provides Mr Sim's credentials as a banking and debt market professional with 18 years experience, including as a teaching fellow at Macquarie University—teaching Master of Applied Finance Students
 - explains how a business like Jemena structures its debt portfolio, highlighting the strong preference for long term debt, moderated by the need to manage refinancing risk and obtain debt at a reasonable price. Mr Sim's ideal portfolio would have an average term-to-maturity of over 12 years, and
 - explains that, when rating a company like Jemena, rating agencies take into account the credit-worthiness of the parent company (in this case Singapore Power, while in the cases of other regulated businesses this may be a state or federal government). Mr Sim explains that, to the extent the parent company has a stronger balance sheet, the subsidiary company receives a higher rating than it would have achieved on a stand-alone basis.

Mr Sim's statement (as well as the statements of Treasurers from other companies that are attached to the JIA submission) provides strong new evidence that:

- despite the AER's assertion on page 120 of the Draft Decision, network businesses do in fact seek to issue long-term debt as a matter of preference, and
- that the hypothetical business that should be used to set the benchmark credit rating is a stand-alone private business.

Closing Comment

Thank you for considering this submission. Should you have any questions, please contact Anton Murashev, Jemena's Manager Asset Regulation & Strategy (anton.murahsev@jemena.com.au, 03 8544 9036) in the first instance.

Yours sincerely,

A handwritten signature in black ink, appearing to be 'PA', with a long horizontal flourish extending to the right.

Paul Adams
Chief Executive Officer