

*Major Energy Users, Inc  
and  
Members of the Energy Roundtable*

**AER review of the WACC  
(weighted average cost of capital)**

A view of the Draft Decision  
December 2008

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# WACC – the key elements

- The risk reduction program in the Rules
- The competitive world and WACC
- Risk free rate
- Market risk premium
- Gearing
- Equity beta
- Credit rating
- Compounding conservatism
- About investment

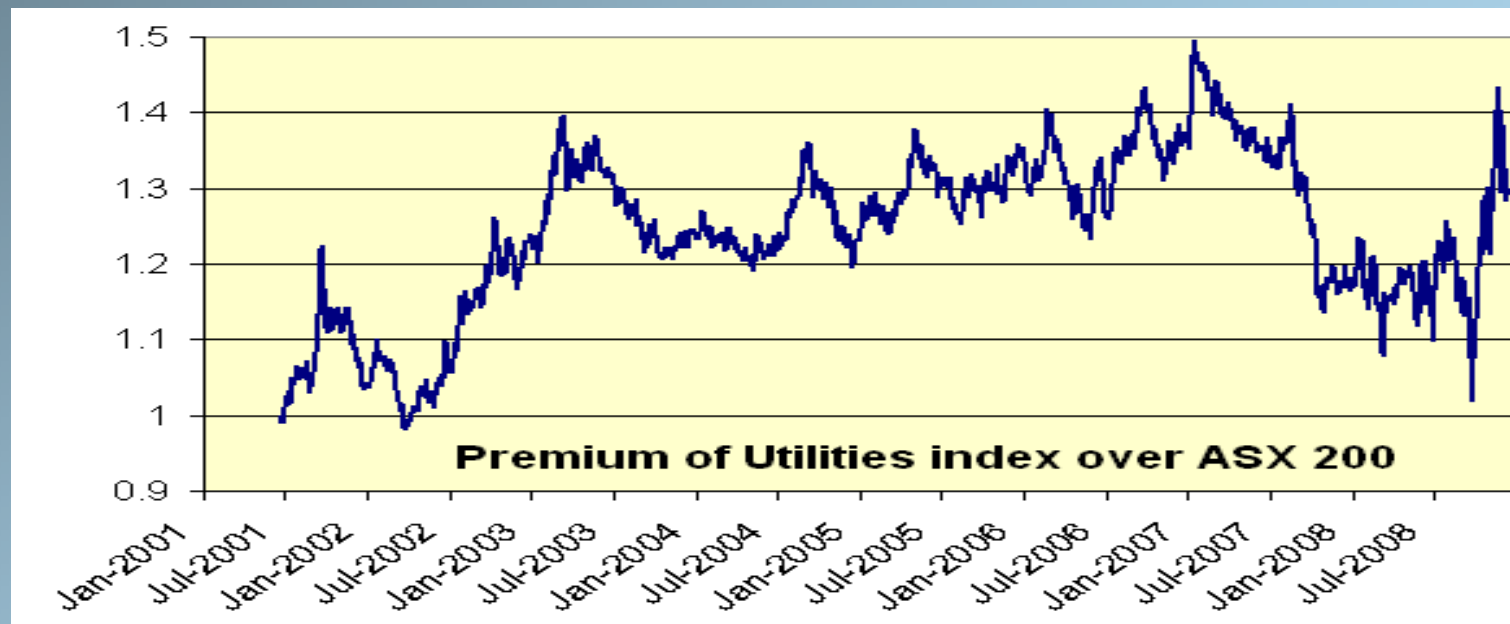
# The risk reduction program

- From 2006, the risks faced by regulated Utilities have reduced significantly, from an already attractive level
- We now have
  - An ex ante capex program which allows the businesses to invest where they want, with little control
  - If the proposed capex program is wrong, there is the “contingent capex” program to help out
  - The regulatory roll in of actual capex removes the risk of inefficient capex
  - Assets can be replaced regardless of any life remaining on completion of the economic life, or if there is a high failure rate before then
  - The propose/respond model effectively used allows the business to maximise opex and capex, regardless of ability to pay – see the NSW draft decisions
  - Service standards are reduced to allow for capex programs
  - Payment for service is effectively guaranteed



# The competitive world and WACC

- The Utilities market index (XUJ) has consistently outperformed the market average, ASX 200
- The reason for this is that regulators have consistently granted higher WACCs than the market average, despite the high cash flow security regulated monopolies have
- MEU members have shared their internal WACCs with us and currently 8% is not unusual. Compare this to the AER DD of 8.6%



# The RFR and MRP

- The MEU has supported the previous ACCC view that the risk free rate should equate to the regulatory period, but the Competition Tribunal, incorrectly in our view, said that it must be 10 year CGS
- We support the AER view on matching regulatory period and CGS rate
- There is clear market evidence that the MRP varies considerably with time.
- The average has been about 6% over the long haul, but evidence shows that the premium has fallen in recent times, although in the last 2-3 years as the market overheated, it was higher than the average
- There is no doubt that currently it is negative
- The MEU considers that 6% is still too conservative as a reasonable period recent average



# Gearing

- The MEU considers that gearing at 60% debt is not reflective of the actual market, and is conservative
- Based on 2007 financial reports, 70% would be the norm

	Regulated Business	Gearing <sup>12</sup>
<b>Public ownership</b>		
Qld Government	Powerlink	62%
	Ergon	69%
	Energex	42%
NSW government	TransGrid	56%
	Country Energy	83%
	EnergyAustralia	72%
	Integral Energy	68%
Tas government	Transend	32%
	Aurora	70%
<b>Private ownership</b>		
Electricity	SP Ausnet (PowerNet, Vic east DB, gas)	65%
	Spark Infrastructure (ETSA, Powercor, Citipower)	54%
	ElectraNet (41% owned by Powerlink)	96% <sup>13</sup>
	DUET (66% United Energy, gas)	79%
	CitySpring (Basslink)	82%
	APT (Murraylink, Directlink, gas )	78%
Gas	Envestra	91%
	Jemena (Singapore Power)	80%
Other	B&B Infrastructure	67%

# Equity beta

- Equity beta reflects non-diversifiable risk and much of the risk has been removed
- The ESCV determined that 0.7 is the correct long term value in its gas distribution review in 2007
- In 2006, ESCoSA considered that 0.8 was the best value for ETSA Utilities review but on the basis of regulatory precedent moved to 0.9
- The AER value of 0.8 is conservative, but has been influenced by recent events as regulated businesses are seen by the market as highly geared.
- Yet the notional business is geared at 60% debt – lower than the actual gearing – and a lower equity beta value (0.7) is more reflective of the lower gearing
- Deep and long term analysis shows 0.7 is more typical of utilities' risks

# Gamma

- The has been extensive debate as to what level of imputation is actually used
- Historically 0.5 has been used as an average
- Those who consider imputation works argue a higher level, those who do not, consider gamma should be low
- The investment is being made in the Australian market, with all its challenges and benefits
- Overseas investors know what occurs and still invest here even if they can't access the imputation credits
- This implies a gamma of 1.0 should apply across the board
- Gamma = 1.0 should apply to the government owned businesses, as to do otherwise is just an increase in tax



# Credit rating

- Businesses with high gearing (eg ElectraNet) can get a credit rating of BBB+
- Those with lower but still high gearing (~80%) like Ergon have got a credit rating of AA+
- Even DBs with a retail arm (eg EnergyAustralia) have a credit rating of AA
- It is not ownership that sets the credit rating, but the likelihood the debt will be repaid, that determines it
- Regulated businesses have a very high certainty of cash flow, with a product that has low elasticity of demand
- Why are we seeing a low credit rating of A-?

# Compounding conservatism

- The AER recognises this is an issue
- Yet we still have a conservative MRP (6% where 5% is arguable), equity beta (0.8 rather than 0.7), credit rating (A- rather than A+), gamma (0.65 rather than 0.85)

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Parameters	% debt	DRP	$\beta_e$	MRP	% equity	RFR	Nominal WACC
AER	60%	2%	1	6%	40%	6%	9.6%
AER + 10%	54%	2.2%	1.1	6.6%	46%	6%	10.5%
AER - 10%	66%	1.8%	0.9	5.5%	34%	6%	8.8%
MEU	70%	1.5%	0.7	5.5%	30%	6%	8.2%

- This example shows that a 10% increase in each of the key parameters leads to a 25% increase in the premium above the RFR
- Why continue to build conservatism at each element?

# **A view from the vested interests**

- ENA uses the “pub test” for common sense on financial investments (The Australian 15 Dec 08)
- The ENA says the AER proposed WACC will:
  - Limit NSPs to connect renewable generators
  - Not recognise the global market needs
  - Reduce the funds available for investment in ageing assets
- In fact:
  - Under the Rules generators negotiate for connection
  - A lower WACC would imply lower connection costs
  - NSW NSPs have recently cited an increased need (some \$18 Bn) for funds from the financial markets, but have not raised any concern about accessing funds
  - 8.6% WACC with a guarantee of revenue and a very low investment risk, is way better than 8% WACC and fierce competition



# Is infrastructure investment being stultified?

- There is an argument that with the high WACC used in the past it overly encouraged investment
- Look at the growth in capex/RAB, noting that RAB has increased too – and it is the same for DBs

TNSP	Allowed capex/RAB at each reset <sup>*claimed</sup>		
	First reset	Second reset	Third reset
TransGrid (NSW)	46	40	62*
SPA (Vic)	26	40	
PowerLink (Qld)	46	60	
ElectraNet (SA)	43	48	
Transend (Tas)	56	69*	

- This clearly shows the WACC used to date has incentivised massive investment – maybe too much!
- Capex claims have been made (eg NSW DBs) that imply that new equity has to be raised (from a government that has to cut back on investment?), so the cash must be from increased debt



## **“Compare the pair”**

<b>Competitive market</b>	<b>Regulated market</b>
<b>Massive upheaval</b>	<b>Business as usual</b>
<b>Falling sales (volume &amp; cash)</b>	<b>Increased sales (volume and cash)</b>
<b>Major cost cutting, labour shedding</b>	<b>Guaranteed revenue, low elasticity in demand</b>
<b>Capex reduced</b>	<b>Capex increased</b>
<b>Major increases in costs (ETS, MRET, network charges, gas,)</b>	<b>Opex increased</b>
<b>Low share price, low dividend</b>	<b>High WACC slightly reduced</b>

- **Where would you invest?**
- **Banks have the funds – they are just wary of where they invest**



# Conclusions

- The risk profile for the NSPs was already low but since late 2006 it has reduced further
- The WACC should have reduced then but, if anything, it increased
- The AER has addressed some of the glaring anomalies but still persists in using values which remain conservative
- There is no historic evidence that there has been a lack of investment in regulated businesses – if anything the trend is increasing investment
- There is no evidence that investment in regulated utilities will reduce if the WACC reduces, despite the observations from the fear-makers
- Any regulated WACC above 8.6% will have a chilling effect on downstream investments when added to other energy imposts faced

