Multinet GAS

321 Ferntree Gully Road
Mount Waverley Vic 3149
Australia

20 April 2007

Mr Mike Buckley
General Manager
Network Regulation North
Australian Energy Regulator
PO Box 1199
Dickson ACT 2602

Dear Mike

Re: Cost of Capital - Bias in the Risk Free Rate

Multinet appreciates the opportunity to respond to the AER on issues regarding the bias in the risk free rate in the context of calculating the Powerlink Revenue Cap Determination. Powerlink has provided the AER with a report by NERA on the observed downward bias in the indexed Commonwealth bond yields, historically used as a proxy for the real risk free rate by Australian regulators.

Like Powerlink, Multinet supports the findings of NERA and urges the AER to consider this important new research. This report by NERA has also been submitted to the Essential Services Commission (ESC) by the Victorian Gas Distribution Businesses, including Multinet, for consideration in the Gas Access Arrangement Review 2008-2012. These submissions are available on the ESC's website and may be of value to the AER when considering this new evidence.

The NERA report has raised a serious issue regarding the appropriateness of using observed yields on CGS as a proxy for the real risk free rate. Substantial evidence is emerging that long term anomalies have developed in the yields on Commonwealth Government Securities (CGS) due to a shortage of supply and that it is inadequate to solely rely on the yields on indexed-linked Commonwealth bonds as a proxy for the real risk free rate.

In a number of decisions over recent years regulators in the UK have recognised the impact of the declining supply and increasing demand for government bonds and have responded by adopting higher risk free rates than prevailing market yields on government securities. As shown in Table 3.1 of the NERA report, UK regulators have added an adjustment of between 30 to 100 basis points to yields on government securities when estimating the risk free rate.

Until recently, Australian regulators have taken the view that conditions in the UK government bond market are different to those in the equivalent Australian market. However, as noted by Powerlink, the RBA has made a number of recent statements in its periodic reporting that the spread between yields on indexed and nominal CGS can no longer be explained by expected inflation alone. NERA has undertaken research and analysis that investigates this RBA commentary and seeks to explain and quantify the difference and examines whether there is a similar effect for nominal bonds.

NERA has investigated trends in supply and demand for indexed and nominal CGS and has demonstrated a substantial movement in the supply and demand balance over recent years. This change in the supply and demand explains the inadequacy of expected inflation to account for the difference in yields between indexed and nominal CGS. Similarly it suggests yields on nominal bond yields may be an inadequate proxy for the nominal risk free rate.

NERA's analysis demonstrates that there is a relative downward bias of 20 basis points between the yields on real and nominal 10 year CGS. It has provisionally estimated the absolute bias on the true risk free rate in the yield on nominal bonds to be between 42 and 44 basis points. NERA is finalising a more reliable estimate of this bias in nominal bond yields and is expected to complete this work within the month. Multinet believes the work of NERA is robust and has a sound theoretical and analytical basis and urges the AER to consider this additional research when it is available.

It is now becoming clear that the market distortions identified by the RBA and quantified by NERA demonstrate that what has been accepted as standard practice among regulators is not adequate for estimating the risk free rate in arriving at rate of return in regulatory decisions. It is essential that regulators and regulated businesses give full and thorough consideration to this matter to ensure that estimates of the cost of capital are not subject to systematic error. It will also be important find an appropriate mechanism for estimating the risk free rate, which takes into consideration this new evidence and is a simple and transparent as possible.

Until this is done Multinet supports Powerlink's request for an upwards adjustment to reflect both the relative and absolute biases identified by NERA. Multinet has assessed the weight of new evidence on the relative bias in the yields on CGS yields and considers the new evidence to be robust and compelling. Powerlink's request represents a conservative estimate of the bias as preliminary evidence by NERA indicates that an adjustment for the absolute bias on nominal bonds may also be required.

Multinet recognises the Powerlink Revenue Determination is in an advanced stage and the importance for the AER to deliver a timely final decision. However, the materiality of this issue and the forewarning Powerlink has given in previous rounds of consultation warrant the AER to give this sufficient consideration to this issue. If the AER were to reject this new evidence without giving it consideration, the service provider risks being unable to recover legitimate costs.

Multinet submits that that the AER should consider the additional research on the absolute bias in the risk free rate, which is expected within the month, if it is available before the Final Decision.

Should you have any questions regarding the above, please do not hesitate to contact me on (03) 8540 7888.

Yours sincerely

Hugh Gleeson
Chief Executive Officer