RARE

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27 January 2009

Mr Chris Pattas
General Manager
Network Regulation South Branch
Australian Energy Regulator (AER)
GPO Box 520
Melbourne VIC 3001

Re: RARE Infrastructure Limited's ("RARE") submission on the AER review of WACC parameters for electricity transmission and distribution networks

RARE is a 100% Australian owned fund manager, currently investing $900 mn of funds sourced from clients in Australia, North America and Europe into global listed infrastructure securities. RARE has complete discretion as to where geographically it invests client funds and currently holds three Australian regulated listed securities governed by the AER in our portfolios. Individual stocks are selected based on the prospective risks and returns for the underlying assets. Hence, higher allowed returns and lower variability of those returns will encourage us to direct more money into Australian regulated assets.

We were extremely disappointed with the proposed statement of revised WACC parameters issued on 11 December 2008, and with the briefing attended by the AER Chairman on 18 December 2008. In particular, we found that the proposed parameters were inconsistent with previous comments made by the Chairman and CEO. As a fund manager investing globally, we have a choice to invest in Australian regulated networks or in other securities. Our investment universe includes over 200 listed securities with assets and operations in many developed and developing countries around the world.

When RARE conducted a "Regulated Utility Industry" study in July 2007, we found that more attractive returns were available to electricity and gas networks in Spain, the United Kingdom and Italy than in Australia. In particular, the Italian transmission networks can access a 3% return (on assets) incentive for investing in network expansions and new entry points to their national grids. These levels of returns were an important driver of establishing portfolio positions in Snam Rete Gas SpA and Terna SpA.

Reductions in the allowed returns for Australian electricity networks make us less likely to put our client funds to work in AER regulated assets. A reduction in returns for the Spanish gas transmission company Enagas in December 2006 lead to RARE reducing our portfolio weight in this stock. And similarly, new capital raisings will be impaired for AER regulated assets due to the less attractive returns available from investing in networks with a lower allowed WACC.

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In RARE's view regulatory reviews that negatively surprise the capital markets have both direct and indirect consequences. The direct impact is on lower future revenues and lower values for regulated assets. The indirect impact is the increased uncertainty and loss of financier and investor confidence that results in an increase in the required cost of capital. A higher cost of debt and equity for regulated assets increases the costs for building, operating and maintaining these assets and eventually gets passed onto consumers in higher tariffs.

Implementing the draft proposals for WACC parameters could lead to credit rating reductions for both electricity and gas network companies in Australia. Alternatively, the threat of credit rating reviews may cause regulated companies to issue equity (as Envestra is doing with their rights issue in February) or take other actions that are detrimental to shareholder value. The crystallisation of these types of risks makes potential equity investors less likely to deploy funds into regulated assets now and in the future.

In terms of the time period used to estimate equity betas, the period of 6 years and 8 months includes one of the largest stock market booms in modern history. And similarly, the period used for credit ratings includes a credit boom that has only been witnessed on a couple of other occasions in the previous 150 years.

All of our internal beta estimates used in modelling and valuing listed Australian securities are above the 0.8 equity beta in the proposed statement. In one case we estimate the equity beta at 1.19. We also believe the proposed reduction in equity beta is inconsistent with the mean of 0.91 and the median of 0.90 for final determinations over the last four years.

In terms of access to capital at the moment and for the foreseeable future, it has to be noted that the capital markets are credit-constrained and that huge amounts of equity wealth have been lost during the last year and a half. The large investment programs being undertaken by AER regulated networks must be financed in competitive capital markets. Based on our valuations of more than 200 global listed infrastructure securities, we can see many more attractive opportunities to invest in companies with greater than 20% per annum prospective returns for shareholders.

In formulating the final WACC parameters please keep in mind the need to provide attractive returns so that regulated networks can finance their investments in the debt and equity markets, which have become increasingly competitive. Other regulators who we have recently met, such as Ofgem and FERC, appear significantly more aware of the uncertainty and increased cost of capital.

Yours faithfully

Richard Elmslie
Investment Director &
Senior Portfolio Manager

Nick Langley
Investment Director &
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