Submission in response to WACC issues arising in the AER's Draft Distribution Determination for ETSA Utilities

Prepared jointly by the
Victorian Electricity Distribution Businesses

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1. Introduction and Summary

This response relates to the AER's Draft Distribution Determination for ETSA Utilities for the 2010/11 to 2014/15 period in relation to two issues relating to the WACC that may have a bearing on the AER's approach to regulatory decision making in other reviews, including the current Victorian distribution price control review. Accordingly, the Victorian DBs are lodging this submission, which focuses on the AER's assessment of the Market Risk Premium (MRP) and the value of imputation credits (gamma).

In relation to the MRP, the Victorian DBs consider that:

- Contrary to the AER's assertion that market volatility "appears to be reverting to pre-GFC levels" there is ample evidence available today which demonstrates that:
  - volatility and uncertainty continue to pervade capital markets; and
  - the outlook for the global economy and capital markets remains very fragile, which places upward pressure on the MRP.
- The National Electricity Law requires the AER to adopt a cautious approach to setting the WACC parameters, so that service providers have a reasonable prospect of at least recovering their efficient costs. In the current market conditions, the National Electricity Objective and the Revenue and Pricing Principles are best satisfied by adopting an MRP above the value specified in the Statement of Regulatory Intent (SORI).

In relation to gamma, the Victorian DBs consider that ample persuasive evidence - including new evidence that has become available since the finalisation of the SORI – has now been put to the AER to demonstrate that a gamma value of 0.65 is not appropriate and that a gamma value that does not exceed 0.5 should be adopted in accordance with the provisions contained in clauses 6.5.4(g) and (h) of the National Electricity Rules.

The Victorian DBs are continuing to engage with independent experts to ensure that the highest quality assessments of gamma and MRP are made available to the AER during the Victorian electricity distribution price review. We expect to lodge further submissions in relation to these matters over the course of the Victorian review.

In the meantime, more detailed submissions on the position adopted by the AER in the South Australian Draft Decision on these matters are set out below.

2. Market Risk Premium

In relation to the MRP pages 310 and 311 of the AER's South Australian Draft Decision state:

> "During the WACC review, the AER considered that prevailing conditions, dominated by the GFC, justified an increase in the MRP to 6.5 per cent, noting that this was either the result of the medium-term MRP being above its long-term value, or that there had been a structural break. The AER now considers that market volatility appears to be reverting to pre-GFC levels, implying that the MRP may also be returning to the AER's best estimate of the long-term equilibrium MRP of 6 per cent...

The AER considers that a MRP of 6.5 per cent may therefore be generous when accounting for current prevailing conditions.

That said, the AER considers that, while there is evidence to suggest that the MRP may be returning to the AER's previous best estimate, at this point in time there appears to be insufficient information to justify a departure from the MRP defined in the SORI. However, the AER will continue to monitor financial market conditions and will re-evaluate its position for the final decision."

In their regulatory proposals (lodged in November 2009) some Victorian DBs noted that recent comments from the market commentators[2] pointed to the fragility of the global economic outlook, the risk of another credit crunch and a double dip recession. On the basis of these comments, the Victorian DBs' November 2009 regulatory proposals noted that it would be extremely premature to suggest that the market cost of equity has returned to levels that preceded the global financial crisis.

Since November 2009, further commentary and evidence has emerged regarding the risks to global economic growth and capital markets in the wake of the global financial crisis.

On the outlook for equity markets, Morgan Stanley published a research note in late January 2010 predicting on-going share price volatility as well as significant falls in share prices. Writing in The Age on 29 January 2010, Michael Pascoe explained that Morgan Stanley consider that official support for risk assets is starting to be withdrawn and a monetary policy tightening cycle is getting underway in the healthier economies. Michael Pascoe quoted Morgan Stanley's Gerard Minack's observation that greater market volatility is expected[3]:

"We don't want to over-emphasise this. On a six-month view we think developed world equities will be lower. However, in a market where we expect less trend and more volatility, we're aiming to finesse our shift to a bearish view on the market."

In the media release issued by the Reserve Bank on 2 February 2010 to explain its latest monetary policy decision, Governor Glenn Stevens noted the new concerns regarding sovereign risk:

"Global financial markets are functioning much better than they were a year ago. Credit conditions nonetheless remain difficult in the major countries as banks continue to face loan losses associated with the period of economic weakness. Concerns regarding some sovereigns have increased."

The following commentary (which appeared in The Age on 5 February 2010) illustrates the basis of the concerns noted by the Reserve Bank:

"Growing fears over ballooning public debt in Greece and Portugal have sparked a fresh round of global credit markets jitters, which threaten to push up funding costs for Australian banks.

The market for credit default swaps - which gauge the risk of default by a company or government - suggests that investors are increasingly anxious about lending on global markets."

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2 Including Dr Adrian Blundell-Wignall, the deputy director of financial and enterprise affairs at the OECD.

3 Michael Pascoe, "Bears are back as Morgan Stanley tips share slump", *The Age*, 29 January 2010.

Against this backdrop, global equity markets remain highly volatile, as noted in the following article which appeared in the Financial Times[4] on 4 February 2010:

> "Growing fears over the health of Europe's weakest economies rocked global markets on Thursday, sparking sharp falls in shares on the continent and a worldwide flight to the safety of the US dollar and Treasuries.
>
> The impact of declining sentiment in Europe was compounded in the US by poor employment data, with the number of American workers claiming jobless benefits rising unexpectedly last week…
>
> The S&P 500 was down 3.11 percent, to 1,063.11, its lowest level in three months and the worst day's fall since April 2009. The FTSE 100 closed down 2.2 per cent and the FTSE Eurofirst 300 was 2.8 per cent lower.
>
> The debt markets of Europe's so-called peripheral economies also came under pressure as the yield spread between their bonds and Germany, the benchmark market, widened sharply.
>
> Gary Jenkins, head of fixed income research at Evolution Securities in London, said: 'The risk aversion trade is back on as the debt problems of Europe are for the first time bringing down global markets. Corporate earnings may come in strongly [in the US], but investors are more concerned about the possible default of a sovereign European nation.'
>
> With the UK putting its quantitative easing programme on hold and the US soon to end its credit easing initiative, investors also fear that the markets will come under intense pressure without this stimulus."

Further relevant commentary appeared in a piece titled "Volatility soars with markets in quandary" which was published in The Age on 9 February 2009. That article stated:

> "Even the experts cannot agree on whether the world's jittery share markets are having a hiccup or a heart attack.
>
> The closing of the local market a handful of points higher yesterday (it was up 7.3 points at 4521.4) brought the Australian Securities Exchange's benchmark S&P/ASX 200 Index back to almost exactly where it was a week earlier.
>
> In between times, billions of dollars were made and lost on positive and negative swings of about 3 per cent in either direction in global sharemarkets. That kind of movement on the local exchange added, and then subtracted, $30 billion in four trading days last week. And then there were the sharp movements in currencies, and interest rate-related securities....
>
> The ASX has shed almost 9 per cent, or about 435 points, from its January peak, which is close to the accepted 10 per cent fall for what analysts call a "correction" - when the market has run too far, too fast."

It is highly instructive that the commentaries cited above were published after the AER released its South Australian Draft Decision in late November 2009. The inconsistency between these statements and the AER's assertion that market volatility "appears to be reverting to pre-GFC levels" is further evidence of the volatility and uncertainty that continues to pervade the market. There is clear evidence that the outlook for the global economy and capital markets remains very fragile, which places upward pressure on the MRP.

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[4] Oakley et al, "Europe fears rock global markets", *The Financial Times*, 4 February 2010, http://www.ft.com/cms/s/0/a124518a-11cb-11df-b6e3-00144feab49a.html?nclick_check=1

The South Australian Draft Decision (page 297) notes correctly that the following Revenue and Pricing Principles, set out in section 7A of the National Electricity Law, are of particular relevance to the method used to estimate the MRP:

- providing a service provider with a reasonable opportunity to recover at least the efficient costs;
- providing a service provider with effective incentives in order to promote efficient investment; and
- having regard to the economic costs and risks of the potential for under and over investment.

The South Australian Draft Decision also notes correctly that clause 6.5.4(e) of the Rules provides that the rate of return must be a forward-looking rate of return that is commensurate with prevailing conditions in the market for funds and the risk involved in providing regulated distribution services.

Having regard to the requirements of these provisions and the evidence cited above, the adoption of an MRP value *below* the value specified in the SORI – as alluded to by the AER on pages 310 and 311 of the South Australian Draft Decision – could not be justified.

The Victorian DBs maintain their view – as set out in their respective November 2009 regulatory proposals – that the SORI value for the MRP understates the MRP that is likely to prevail over the forthcoming regulatory period. Therefore, if the SORI value were to be applied to set the allowance for the cost of capital over the forthcoming regulatory period, there would be insufficient incentives for efficient investment over the period, and this would be contrary to the long term interests of consumers and hence the National Electricity Objective.

The National Electricity Law requires the AER to adopt a cautious approach to setting the WACC parameters, so that service providers have a reasonable prospect of at least recovering their efficient costs. It is evident from the South Australian Draft Decision, however, that the AER appears to be prematurely anticipating the MRP reverting to its long term trend. In the current market conditions, the National Electricity Objective is best satisfied by adopting an MRP above the value specified in the SORI. This view is consistent with the Victorian DBs' regulatory proposals, which argued that there is a strong case for the AER to increase the value of MRP from the SORI value of 6.5% for this particular determination, given:

- the on-going uncertainty regarding the outlook for global economic and capital market conditions in the wake of the global financial crisis;
- the new evidence presented regarding investors' forward-looking required rates of return in the present environment of on-going high uncertainty; and
- the requirements of the National Electricity Objective and the Revenue and Pricing Principles set out in the National Electricity Law.

3. Gamma

The AER's South Australian Draft Decision adopted a value for gamma of 0.65 in response to ETSA Utilities' proposal that a gamma value of 0.5 should be adopted.

The response of ETSA Utilities to the AER's South Australian Draft Decision reinforces the evidence in support of the adoption of a value for gamma that does not exceed 0.5. In particular, ETSA Utilities' revised regulatory proposal responds to the various matters raised in the AER's Draft Decision, and in so doing:

- provides direct and observable evidence which clearly demonstrates that the AER's assumption of a 100 percent payout ratio is at odds with the actual behavior of firms[5], and there is no theoretical or empirical basis to justify the AER's continued assumption of a payout ratio of 100 percent[6];

- demonstrates that the concerns expressed by the AER in the South Australian Draft Decision regarding the SFG dividend drop-off study and Skeels' subsequent work (cited by ETSA Utilities and the Victorian DBs to substantiate the value of theta) are unfounded; and

- taxation statistics provide limited information on the market-based valuation of imputation credits, and the AER has averaged the taxation statistics with the results of a dividend drop-off study in a manner which will overstate the true value of imputation credits.

In relation to the third point noted above, page 194 of ETSA Utilities' revised regulatory proposal states:

> "ATO statistics by construction must be an upper bound on the possible range of theta. Taxation redemption rates will only provide an insight as to what the maximum value of theta could be. ATO statistics do not contain any information about what an investor would pay for the imputation credit. To average a point estimate from a dividend drop-off study with the maximum theoretical value will create an upward bias by construction in the value of theta. ETSA Utilities considers that this is a more than a deficiency in methodology, it raises a fundamental question as to the reasonableness of the AER's decision…
>
> ETSA Utilities considers that the effect of the AER's methodology creates an inherently upwards bias in the estimation of theta."

The Victorian DBs consider that ample persuasive evidence - including new evidence that has become available since the finalisation of the SORI – has now been put to the AER to demonstrate that a gamma value of 0.65 is not appropriate and that an appropriate lower gamma value should be adopted in accordance with the provisions contained in clauses 6.5.4(g) and (h) of the NER.

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[5] NERA, *Payout Ratio of Regulated Firms*, 5 January 2010, submitted as Attachment I.1 of ETSA Utilities' revised regulatory proposal.

[6] R Officer, *Estimating the Distribution Rate of Imputation Tax Credits: Questions Raised by ETSA's Advisers*, 23 June 2009.