



31 August 2001

Mr Michael Rawstron  
General Manager  
Regulatory Affairs - Electricity  
Australian Competition and Consumer Commission  
P.O. Box 1199  
Dickson ACT 2602

Dear Michael,

### **Response to ACCC Draft Decision on Powerlink Revenue Cap**

The purpose of this letter is to provide SPI PowerNet's comments on the ACCC's Draft Decision on the Queensland Transmission Network Revenue Cap for 2002-2006/07. SPI PowerNet has a strong interest in the approach taken by ACCC in this Draft Decision as the Company will commence the formal process for its revenue cap review later this year. It is in this context, rather than as a direct stakeholder per se, that SPI PowerNet makes this response.

We wish to make comments in five main areas:

- the cost of capital;
- the legal discretion available to ACCC in setting the opening value of the regulated asset base (RAB);
- the proposed treatment of asset stranding risk;
- the use of benchmarking; and
- the imposition of mandatory service levels.

While these represent the key areas of concern to SPI PowerNet arising out of the Draft Decision, our response is not exhaustive.

#### *The cost of capital*

In relation to the cost of capital, SPI PowerNet has concerns regarding: whether the vanilla WACC is being used appropriately in the revenue calculation; the definition of the risk free rate; the cost of debt; calculation of the asset beta; and the treatment of taxation.

- **Appropriate use of the vanilla WACC** – SPI PowerNet understands that the vanilla WACC as listed in Table 2.2 should be the WACC measure used in the determination of the revenue requirement. This WACC is often described as a post-tax nominal WACC. In view of this, there is some confusion in relation to

how the vanilla WACC in Table 2.2 is related to the post-tax nominal WACC listed separately in the same table, and at a substantially lower value.

This confusion is amplified in the Conclusion (section 2.11), which states that on the basis of its estimate, including a post tax nominal return on equity of 11.71% and a cost of debt of 6.91% together with a gearing ratio of 60/40: “This translates to a post tax nominal WACC of 7.00% ...”. Adopting the vanilla formula for the WACC and the ACCC’s parameter estimates indicates a post tax nominal WACC of 8.83%. The Draft Decision gives no indication of how the 7% number for the WACC is derived.

- **Definition of the risk free rate** – In the Draft Decision the ACCC has adopted a 5½ year 40 day moving average as its estimate of the risk free rate. The argument for using a 5½ year rate instead of the more conventional long term 10 year Commonwealth Bond rate is that the regulatory period is relatively short. The Draft Decision goes on to state that: “While there is considerable support for the use of bond rates with terms corresponding to the life of the assets, the Commission has stated in previous decisions that they are not appropriate approximations of the risk free rate. The CAPM model used by the Commission is a single period model and given that investors review investments over short periods, a shorter term bond rate is the appropriate measure of the risk free rate.”

The arguments adopted by the Commission for justifying the use of a 5 year risk-free rate are not valid because this benchmark is inconsistent with the way that CAPM is applied in Australia and does not match the long term nature of investment in infrastructure assets.

The estimates of market risk premiums, a critical parameter of the CAPM model, have typically been derived using 10 year government bond rates and therefore to use a 5 year rate could be inconsistent with the estimates of the market risk premium of 6% adopted by the Draft Decision.

Moreover, a company, when evaluating an investment decision, must adopt an opportunity cost of capital consistent with the period of the cash flows being generated by the investment (or assets). In so far as transmission involves heavy capital investment in long term assets, then a long term base to the cost of capital is the appropriate measure. The length of the regulatory review is irrelevant to the term chosen for the risk free rate. It is the nature of the investment that is critical. The fact that the regulatory review is done at more frequent intervals than the period of investment, simply means that it may be appropriate to adjust estimates of the returns going forward to maintain the capital base required for electricity transmission. Such reviews could ensure that there are no windfall gains or losses involved in the investment which will affect the risk class of the investment but not the relevant period for the risk free rate. It is the period of the investment that is relevant in setting a cost of capital.

- **Cost of Debt** – In section 2.5 the ACCC adopts a debt margin of 120 basis points which is the mid point of a range of 80 to 160 basis points that the Commission believes the debt financing for the transmission line is likely to attract as a premium. There is little evidence offered by the Commission in the Draft Decision supporting such a debt margin. Moreover, recent evidence provided to SPI PowerNet (as part of our preparation for making a revenue cap application)

by underwriters and investment bankers suggest that a debt margin of 180 to 200 basis points would be more realistic for the BBB to BBB+ long-dated debt rated issues of infrastructure groups such as Powerlink.

- **Betas and Risk** – In the conclusion to this section the ACCC adopts an asset beta of 0.4 and states this: “equates to an equity beta of around 1.0, which is consistent with the equity betas used in the QCA decision.” However, if we adopt the Commission’s decision of the gearing of 60/40 and a debt margin of 120 basis points, the implied asset beta, using the vanilla WACC, is 0.52. There is some inconsistency in the estimates provided in the Draft Decision relative to the statement by ACCC that the vanilla WACC is being used in estimating the WACC.
- **Treatment of Taxation** – The Draft Decision says that ACCC has adopted an effective tax rate of 22.29% based on modelling. In a footnote, the Monkhouse formula is set out, which presumably is used in deriving this effective tax rate, although this is not stated explicitly. In so far as ACCC has adopted such a formula, in fact any formula other than the vanilla WACC, the estimate of the taxation will be inconsistent with the WACC estimated.

#### *Legal discretion in setting the opening value of the RAB*

SPI PowerNet disagrees with ACCC’s view that the Commission does not have the power to adjust a TNSP’s opening asset value at its first revenue determination, and has sought advice from senior counsel on interpretation of the Code that supports SPI PowerNet’s position. Given the regulatory reliance on the building block methodology for revenue determination, without a true asset base value it is not possible for the business to earn a fair and reasonable rate of return, as is its right under the Code. Moreover, every TNSP should have the right to an accurate asset base value at that first revenue determination to ensure it is on a solid and equal footing with other TNSPs going forward.

SPI PowerNet supports and encourages the ACCC’s intention to seek clarification on this issue as soon as possible. The question is of significance to SPI PowerNet, and doubtless to other regulated businesses, and delay in resolution would be unworkable, given the timeframe for SPI PowerNet to finalise its own revenue cap application.

The Company is very confused about ACCC’s stance on this issue. As recently as April this year, PB Associates, in their Network Asset Valuation Review for ACCC made the statement that (p1) “However the Code permits the Commission to require the opening asset value to be independently verified through a process agreed with the National Competition Council....In accordance with this provision of the Code, the Commission has engaged PB Associates to review the optimised depreciated replacement cost (ODRC) valuation conducted by the Consortium.”

This is in stark contrast to ACCC’s statement in the Draft Decision that (p36) “It has always been the Commission’s understanding that in undertaking its role as transmission network revenue regulator, it would accept the 1999 jurisdictional regulator’s valuation without revisiting the sunk valuation of the assets until the first regulatory reset, where the Commission will be able to undertake a ground up valuation of the networks assets.”

In addition to conflicting with the understanding of one of its own consultants, this statement does not accord with statements made by ACCC in relation to the Victorian TNSP in its NEM Access Code Decision of 16 September 1998: “Consequently, the Commission maintains its view expressed in the Draft Decision that it would not accept a derogation which prevents the Commission from taking the option of revaluing the assets at the time the Commission takes over as regulator.”

This is an issue that SPI PowerNet would be pleased to resolve jointly with ACCC as legal differences of view on such a fundamental issue are potentially very damaging to the efficiency and effectiveness of the regulatory system.

#### *The proposed treatment of asset stranding risk*

In its application, Powerlink maintained that it was exposed to significant asset stranding risks that were asymmetric and not captured in the beta estimates used in the CAPM. ACCC has responded to this by refusing to increase Powerlink’s revenues to compensate for this risk, and instead has agreed to underwrite the value of Powerlink’s transmission network should asset stranding occur. While this is potentially a viable way to address this issue, SPI PowerNet would like the Commission to define exactly how it will put this into practice and explain how it is able to provide such guarantees given that, in our understanding at least, the Commission cannot constrain future Commission actions or decisions.

#### *The use of benchmarking*

SPI PowerNet believes that while benchmarking can provide support for operating and maintenance expenditure allowances, the benchmarks used in the Draft Decision should not be regarded as universally applicable. The Company refers the ACCC to its response to the PB Associates report for further detail on why this is so.

#### *The imposition of mandatory service levels*

SPI PowerNet notes that the Commission has not reached a conclusion on the setting of appropriate service standards and proposes to further develop the standards outlined in the draft Regulatory Principles in consultation with all TNSPs. Having regard to the ACCC’s stated intention, SPI PowerNet does not propose to comment on the ACCC’s conclusions regarding Powerlink’s service standards.

However, SPI PowerNet is concerned about the form of the obligation that ACCC has placed on Powerlink in section 7.8 (relating to the target levels for loss of supply events). The Draft Decision states that Powerlink is “...**required to meet** the following targets ...” (emphasis added). SPI PowerNet is concerned about the implications of a mandated service level, if this is what is intended. In the Company’s view, the mandated requirement, as opposed to a reasonable endeavours obligation, raises questions relating to any additional expenditure that may be required to deliver this possibly higher level of service, and the treatment proposed in the event that Powerlink fails to achieve the standards.

Should you have any questions in relation to any aspect of this letter then please don't hesitate to contact me on 03 9567 7467 or Matthew Cole on 03 9567 7465.

Yours sincerely,

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