

Mr Warwick Anderson  
General Manager—Network Regulation Branch  
Australian Energy Regulator  
GPO Box 3131  
Canberra ACT 2601

**SYDNEY**  
201 Elizabeth Street  
PO Box A1000 Sydney South  
NSW 1235 Australia  
T (02) 9284 3000  
F (02) 9284 3456  
[www.transgrid.com.au](http://www.transgrid.com.au)

Dear Mr Anderson

*Warwick*

TransGrid welcomes the opportunity to make a submission on the AER's Draft Decision on Powerlink's Revenue Proposal for the 2012-2017 regulatory control period.

TransGrid notes the detailed form of the Draft Decision and the AER's efforts to be more concise. TransGrid nevertheless has concerns with several positions taken by the AER in the Powerlink Draft Decision and wishes to raise them for review in the spirit of improved regulatory decision making. These concerns include:

1. the AER's treatment of the cost of equity which fails to meet the Revenue and Pricing Principles in the National Electricity Law;
2. the AER's proposed new methodology for calculating the Debt Risk Premium which NERA has assessed as having "serious flaws";
3. the use of labour productivity measures to deflate the real cost of labour to levels that may imply real wage cuts across the sector; and
4. the arbitrary application of efficiency measures across the top of capital projects which have already in their own right been subject to the intensive scrutiny of the AER and its expert advisers and found to be efficient, or adjusted to the level the AER deems to be efficient.

TransGrid has also identified a number of other matters to which we believe the AER should give further consideration and has set these out in the following submission.

### **Cost of Equity**

The AER's treatment of the cost of equity in the Draft Decision appears to be contrary to the guiding principles set out in the National Electricity Law. While the AER's approach appears to be compliant with the National Electricity Rules the resulting outcomes do not contribute to the National Electricity Objective, and are inconsistent with the Revenue and Pricing Principles. The Revenue and Pricing Principles in the National Electricity Law promote economic efficiency in investment, provision of network services and use of the transmission or distribution system. In doing so, they provide that:

- (2) A regulated network service provider should be provided with a reasonable opportunity to recover at least the efficient costs the operator incurs in—
  - (a) providing direct control network services; and
  - (b) complying with a regulatory obligation or requirement or making a regulatory payment.
- (5) A price or charge for the provision of a direct control network service should allow for a return commensurate with the regulatory and commercial risks involved in providing the direct control network service to which that price or charge relates.<sup>1</sup>

---

<sup>1</sup> National Electricity Law, Section 7A.

Given these circumstances it would be appropriate for the AER to expressly recognise this and fully consider a range of options for addressing this conundrum in its final decision.

The National Electricity Rules prescribe that the cost of equity is equal to the risk free rate (Rf) plus the product of beta multiplied by the market risk premium (MRP). The AER's statement of the revised WACC parameters, May 2009 (Statement on WACC) prescribes that the cost of equity is to be measured by reference to:

- the yield on a ten year Commonwealth Government Security (CGS) measured on a spot basis (over 20 trading days);
- a value for the MRP of 6.5 per cent; and
- a beta of 0.8.

The combination of the MRP and beta give rise to a fixed margin above the applicable CGS yield of 5.2%.

During aberrant market conditions, such as those arising during and following the global financial crisis or GFC:

- the 'flight to safety' reduces yields on CGS; and
- conversely, the price of risk – expressed as the MRP – rises.

The approach to determining the cost of equity prescribed in the Statement on WACC:

- causes the fall in CGS yields to be fully reflected; but
- prevents any allowance for the offsetting effect of the rise in the price of risk.

It follows that, during periods of aberrant market conditions, the National Electricity Rules cause the cost of equity to be understated.

This problem was addressed in more detail in an expert report provided with the Energy Networks Association submission<sup>2</sup> to the Australian Energy Markets Commission in response to the AER Rule change proposal to amend Rules for economic regulation of electricity network businesses. See attached document. The report shows that during situations such as the market circumstances following the collapse of Lehman Brothers in 2008 and, more recently, when financial markets have been concerned about the risks associated with European sovereign debt, the AER's approach understates the cost of equity by as much as 200 basis points. At the same time this report provides evidence of a marked increase in the MRP during these periods. That is, when the prevailing market conditions point to an increase in the cost of equity the application of the Statement on WACC produces an estimate that is materially less than would normally be the case.

Clearly, it is inconsistent with the National Electricity Objective (NEO) for the cost of capital to be understated when determining a TNSP's revenue allowance. Rather, the efficiency objectives enshrined in the NEO can be best met by setting prices for prescribed services that allow the recovery of efficient costs, including a cost of capital commensurate with the riskiness of the investment in the assets used to provide the services.<sup>3</sup>

Furthermore, failure to provide an adequate return to equity holders clearly violates the Revenue and Pricing Principles in the National Electricity Law.

The AER should seek out and exercise its existing discretions under the Rules wherever possible to achieve a result consistent with the NEO and the Revenue and Pricing Principles. Powerlink appears to be suggesting an option along these lines in its revised proposal when it argues for a conservative treatment of other WACC related parameters such as the debt risk premium.

---

<sup>2</sup> *Assessment of the AER's proposed WACC Framework: A joint report for the Energy Networks Association*, 8 December 2011.

<sup>3</sup> See for example: *Application by EnergyAustralia and Others* (includes corrigendum dated 1 December 2009) [2009] ACompT 8 (12 November 2009), para 113.

All options for addressing this issue should be expressly explored with reference to the total legal framework and every attempt made to give precedence to the principles set out in the National Electricity Law that guide the AER in the exercise of its functions.

Specifically, the following options should be assessed in this way for possible application in the final Powerlink revenue cap decision:

1. Adjust the MRP upwards to reflect the current prevailing conditions involving an increased equity risk premium.
2. Adjust the Rf to reflect a longer term average rate as IPART did recently.

While in theory the first of these approaches would be appropriate, measuring the prevailing MRP with confidence is not without difficulty. Indeed the expert report<sup>4</sup> recognises this and suggests that the second of these two approaches may be preferable as follows:

*"We note that, as a practical matter, an alternative means of estimating the cost of equity during times of extreme market uncertainty is to set aside the current date risk free rate and instead to adopt a figure that better reflects the market conditions that gave rise to the historical average market risk premium. This was the recommendation of Professor Officer in 2009:*

*Ideally, as I have already indicated, one would estimate the relevant parameters of the CAPM to reflect the expected or required return on equity for the period that the regulatory rate is set. If one is prevented from doing this, either because of a constraint that an average MRP must be used or through estimation problems, then a second beset approach is to use a period that is unaffected by "aberrant market conditions". In effect, the Rf should be estimated from a period that is consistent with the MRP estimate – an 'averaging period' or period of 'equilibrium'."*

This is the approach adopted by IPART in its recent revenue decision for the Sydney desalination plant when it placed significant regard to the long term average risk free rate to set the cost of capital for the plant. The Tribunal stated that:

*"We determined the values for the parameters of the WACC based on market conditions over the 20 days to 28 October 2011. The risk free rate and debt margin have been affected by market volatility and the prolonged weak market following the credit crisis of 2008. The change in these factors has potentially created a disparity between these parameters (for which we use short term average data) and the market risk premium (for which we use long term average data).*

*However, the effects of this disparity are mitigated by our decision to use a point estimate of 6.7%, which is 80 basis points higher than the midpoint of our estimated WACC range. In doing so, we had strong regard to the calculated WACC using longer term averages for market parameters. IPART's point estimate of 6.7% was also the mid point of WACC range using the long term average risk free rate."*

It would be contrary to good regulatory practice, and the intent of the National Electricity Law, for the AER to implement this outcome in the final decision without fully exploring all the options available to it to rectify this situation. At the very least it should expressly acknowledge the problem and set out clearly what options it can and cannot apply to this matter.

Powerlink has suggested a conservative approach to the estimation of other rate of return parameters, such as the debt risk premium, to address this problem. This appears to be worth closer express consideration in coming to the final revenue cap determination.

Other options worthy of further consideration have been suggested in this submission. The most practical of these to implement would be to adopt a longer term average estimate of Rf for use in the CAPM in the same manner as IPART in its decision in relation to the cost of capital to apply to the Sydney desalination plant. This, and other options, should be expressly considered with reference to

---

<sup>4</sup> *Assessment of the AER's proposed WACC Framework: A joint report for the Energy Networks Association*, 8 December 2011, page 19.

the legal framework. In the event that the AER concludes that it cannot lawfully apply an option it should clearly set out the basis for coming to that conclusion.

### **Debt Risk Premium**

The AER's methodology for calculating the Debt Risk Premium amounts to a significant departure from the accepted approach and has not been consulted on prior to its application to Powerlink. TransGrid believes that the change in methodology to such a fundamental element of the regulatory framework should be properly consulted on and considered prior to its use.

TransGrid has sought the advice of NERA on the positions taken by both the AER and Powerlink to the Debt Risk Premium and their expert opinion is attached to this submission.

In summary NERA found that whilst the approach of using yields on a sample of bonds was a significant improvement on a previous approach of using the yield on a single bond (albeit averaged with an extrapolated Bloomberg FVC) it was insufficiently robust to be relied on to set the DRP or to dismiss the Bloomberg fair value curve.

NERA found that several aspects of the AER's analysis warrant further development and/or refinements before its approach could be relied on to produce a reliable estimate of the DRP. NERA also found there was no sound justification to disregard the Bloomberg fair value curve. NERA go on to note that the Australian Competition Tribunal has already given careful consideration to the use of the Bloomberg fair value curve in the Envestra case during times of aberrant market conditions and not found cause to reject its use.

TransGrid also has significant concerns with the outcomes of the application of the CAPM model in conjunction with a 'spot' rate value for the risk free rate of return, and longer term average values for equity beta and market risk premium as set out in the current Statement on WACC. Under the market conditions in operation at the time of the Powerlink draft revenue cap decision the prevailing cost of equity is materially understated. Carrying this approach through to the final revenue cap decision would be inconsistent with the Revenue and Pricing Principles in the National Electricity Law as set out above, and would also be inconsistent with advancing the National Electricity Objective. This latter point has been discussed further in the earlier comments on the cost of equity.

### **Labour Productivity Factor**

In the Draft Decision, the AER imposed a Labour Productivity Factor on Powerlink's labour escalation rate.

The Draft Decision shows a lack of transparency around the derivation of the labour productivity factor. From Powerlink's revised proposal, TransGrid notes that upon seeking clarification of the data, source, methodology and model(s), Powerlink was informed that "the AER sought this information from Deloitte Access Economics, however were informed that the information is confidential and cannot be provided."<sup>5</sup>

On the basis of this information, it would appear that the imposition of the Labour Productivity Factor may not provide Powerlink with a reasonable opportunity to recover its efficient costs and as such, may not give due regard to the Revenue and Pricing Principles.

Of equal concern to TransGrid is the fact that the AER has made a decision without visibility of the methodology or underlying assumptions. The lack of transparency in Deloitte's approach calls into question the credibility of the methodology and data used. Rule 6A.14.2 of the National Electricity Rules requires a draft decision or final decision to set out methodologies and values used and adopted by the AER.<sup>6</sup>

---

<sup>5</sup> Powerlink Queensland, *2013-2017 Revised Revenue Proposal*, January 2012, p31-32.

<sup>6</sup> AEMC, *National Electricity Rules*, Clause 6A.14.2.

### **Capital Expenditure Efficiency Adjustment**

In its Draft Decision, the AER applied an efficiency adjustment to Powerlink's forecast capital expenditure of 1% in the second year of the regulatory control period and 2% in the third, fourth and fifth years.

The AER has applied this adjustment from a recommendation by EMCa, "based on its experience with past transmission reviews and assessments of network service provider costs in various jurisdictions."<sup>7</sup> TransGrid believes that the basis of EMCa's experience does not give due regard to the costs that a prudent operator in the circumstances of Powerlink would require to achieve the capital expenditure objectives stated in the NER. In fact, by EMCa's own admission, "good industry practice allows for an organisation to choose the option of using a minimal Asset Management Policy combined with more detailed asset specific policies."<sup>8</sup> It has not been demonstrated that the efficiency initiatives cited as general examples are necessarily relevant to Powerlink or would lead to greater efficiencies for Powerlink in the delivery of its capital program.

TransGrid believes that the application of an efficiency adjustment to Powerlink's forecast expenditure has not been adequately substantiated by the AER and is not reasonable.

### **Cost Estimation Risk Factor**

In its Draft Decision, the AER did not accept Powerlink's proposal to include a Cost Estimating Risk Factor in its forecast capital expenditure allowance.

The inclusion of a Cost Estimating Risk Factor (CERF) is common practice, and is integral to the methodology used by TNSPs for cost estimating. The CERF accounts for costs that are unforeseen or inherently difficult to forecast at the cost estimation stage of a project, and are therefore not included in base estimates. All major TNSPs in the NEM currently use a similar methodology to manage risk in the early stages of a project's development, and the approach has been accepted by a range of independent expert consultants previously engaged by the AER. It has been accepted by Worley Parsons as being "in line with good industry practice,"<sup>9</sup> SKM as being "methodologically and technically sound,"<sup>10</sup> and PB & Associates on the basis that cost variation risk should be shared equitably between the TNSP and its customers.<sup>11</sup> The AER itself has also regarded the application of a CERF as reasonable in previous decisions.<sup>12</sup>

TransGrid considers that it is unreasonable for the AER to reject the inclusion of an efficient CERF, given that the application of such a factor is common practice in industry, has been carefully scrutinised in previous revenue determinations and has been assessed as an appropriate approach to cost estimating. Where the CERF is an integrated part of a TNSP's estimating methodology, its rejection may not allow a TNSP a reasonable opportunity to recover the efficient costs of meeting the capital expenditure objectives in the National Electricity Rules (NER).

### **Easement Availability**

In the Draft Decision the AER stated that "*Powerlink has assumed it will be unable to acquire 275kV easements for the project in the future and therefore needed to build on existing easements. The AER considers this should have been tested rather than assumed.*"<sup>13</sup>

<sup>7</sup> AER, *Draft Decision: Powerlink Transmission Determination 2012-13 to 2016-17*, November 2011, p107.

<sup>8</sup> EMCa, *Powerlink Revenue Determination: Technical Review*, 6 September 2011, p37.

<sup>9</sup> Worley Parsons, *Review of the Transend Transmission Network Revenue Proposal 2009-2014*, 23 October 2008, p6.

<sup>10</sup> SKM, *Review of ElectraNet Proposal*, 23 November 2007, pp52-55.

<sup>11</sup> PB, *TransGrid Revenue Reset: An Independent Review*, 12 November 2008, p112.

<sup>12</sup> AER, *Decision: Powerlink Queensland Transmission Network Revenue Cap 2007-08 to 2011-12*,

14 June 2007; AER, *Draft Decision: SP AusNet Transmission Determination 2008-09 to 2013-14*,

31 August 2007; AER, *Final Decision: ElectraNet Transmission Determination 2008-09 to 2012-*

13, 11 April 2008; and AER, *Final Decision: TransGrid Transmission Determination 2009-10 to 2013-14*, 28 April 2009.

<sup>13</sup> AER, *Draft Decision: Powerlink Transmission Determination 2012-13 to 2016-17*, November 2011, p131.

TransGrid is concerned as to the nature and extent of testing the AER considers should have been undertaken. TransGrid does not believe it is appropriate or prudent for a TNSP to attempt to acquire easements solely to test whether it is possible to acquire those easements. Short of this, TransGrid believes the most feasible rationale of inability to acquire easements is the consideration of sustainability, environmental, heritage, conservation and community impact extensively articulated in jurisdictional legislation. It has concerns that the AER's requirement to test ability to acquire easements may not be economically efficient, pragmatically possible or acceptable to the community, and suggests that the expertise of experienced infrastructure providers should be a suitable guide to the AER as to the feasibility of easement acquisition. TransGrid believes this is a matter that requires clarification for all TNSPs.

### **Network Support Allowance**

In its Draft Decision, the AER has not provided any allowance for network support for Powerlink. The AER required evidence of a Regulatory Investment Test – Transmission (RIT-T) for the related projects or contractual agreements to assess the proposal for network support.

TransGrid questions whether such a stringent evidentiary requirement for network support is reasonable in all cases, as it is impractical to conduct a RIT-T or enter into network support contracts for network limitations many years in the future. TransGrid acknowledges that variations in actual network support compared to allowance can result in either a positive or negative pass through, but questions the signal given to the market by the AER's rejection of network support allowance in its decision.

Should you require any further clarification on the above matters please contact Nicola Tully, Manager/Revenue Reset on (02) 9284 3120.

Yours sincerely,



**Anthony Meehan**  
*Executive General Manager / Finance and Information Systems*