

14 June 2007

Mr Chris Pattas
General Manager
Network Regulation South Branch
Australian Energy Regulator
GPO Box 520
MELBOURNE VIC 3001

Dear Chris,

NERA REPORT ON ABSOLUTE BIAS AND REVISED WACC PROPOSAL

On 31 May 2007 SP AusNet submitted independent expert advice to the Australian Energy Regulator (AER) from NERA on the relative bias in the risk free rate. NERA indicated that a supplementary report would follow, *Absolute Bias in (Nominal) Commonwealth Government Securities*, which is now finalised. A copy of this report is attached.

NERA's report on the relative bias raised serious issues regarding the appropriateness of using observed yields on Commonwealth Government Securities (CGS) as a proxy for the real risk free rate. NERA established not only the presence of bias but also provided robust quantification of its size, allowing corrective action to be taken by regulators. In summary, NERA noted a relative downward bias of 20 basis points (bp) between the yields on real and nominal 10 year government bonds and made a preliminary assessment on the absolute downward bias which, at the time, was estimated to be between 42-44 bp. NERA foreshadowed that a more reliable analysis would be conducted on the absolute bias in a further report.

NERA's supplementary report demonstrated that the absolute downward bias on the true risk free rate in the yield on nominal bonds is 66 bp rather than as NERA initial estimated in the preliminary report 42-44 bp.

The implication of NERA's findings in both reports is that standard regulatory practice needs to be adapted to take account of the growing bias in CGS yields. Taking this into account regulators would need to:

- increase estimates of the real cost of debt by 20bp (to reflect the 20bp relative bias in indexed CGS yields); and
- increase estimates of the real cost of equity by 86bp (to reflect the 20bp relative bias in indexed CGS and the 66bp bias in nominal CGS).

NERA identifies two approaches to correct for the identified biases, but recommends that instead of adjusting CGS yields, an alternative approach where the risk free rate is set equal to the yield on corporate bonds less the cost of insuring those bonds against default should be adopted. SP AusNet submits that the AER consider adopting this

approach when estimating the real risk free rate for the determination of the cost of capital in a regulatory review.

After reviewing NERA's second report, SP AusNet considers there to be a compelling case that continued use of CGS yields to estimate the risk free rate without recognition of the relative and absolute bias would result in a significant underestimate of the allowed cost of capital for regulated entities. SP AusNet submits that given the credibility of evidence set out in the NERA reports, the AER has compelling reasons to give serious consideration to them in assessing SP AusNet's revised proposal.

SP AusNet recognises the significance of the conclusions in NERA's reports because of the historic and well-accepted assumptions about yields on CGS being a reliable proxy for the risk free rate. Consequently SP AusNet proposes that in addition to the reports that have been provided, NERA make a presentation of its work to assist the AER in making well-informed decisions about NERA's conclusions. The NERA work clearly has implications for other regulated entities and other Australian regulators.

The issue of the appropriateness of relying on CGS as a proxy for the risk free rate has been raised with the Essential Services Commission (ESC) in relation to the gas distribution pricing reviews and the Australian Competition Consumer Commission (ACCC) in relation to the Dawson Valley Pipeline. For this reason, SP AusNet suggests the possibility of involving the ACCC and ESC in NERA's presentation as it is also relevant to their consideration. SP AusNet will be in contact with the AER shortly to discuss this opportunity.

To arrange for any discussions related to the risk-free rate and SP AusNet's Revenue Proposal, please contact either our Transmission Regulation Manager, Tom Hallam on telephone 03 9695 6617 or our Senior Regulatory Economist, Renate Tirpcou on 03 9695 6630.

Yours sincerely,



Charles Popple
General Manager, Regulation and Business Strategy
SP AusNet