energy networks association

4 May 2012

Mr Lyndon Rowe
Chairman
WA Economic Regulation Authority
PO Box 8469, PERTH BC WA 6849

Email address: publicsubmissions@erawa.com.au

Dear Mr Rowe

The Energy Networks Association (ENA) welcomes the opportunity to respond to the Economic Regulation Authority of Western Australia's (ERA) *Draft Decision on Proposed Revisions to the Access Arrangement for the Western Australia Power Network* (Draft Report) published on 29 March 2012. ENA is concerned with a number of aspects of the ERA's Draft Decision and provide these comments for the purpose of informing the Authority's assessment of Western Power's revised access arrangement proposal.

ENA is concerned with the lack of robustness of the framework applied by the WA Economic Regulatory Authority in developing alternative operating cost forecasts. ENA considers that ERA's Draft Decision on operating expenditure risks failing to meet the relevant criteria of the *Electricity Networks Access Code* (the Code). ENA considers that application of the proposed forecasting approach lacks transparency or a rational basis and will lead to greater uncertainty and reduce confidence in the regulatory regime.

ENA has significant concerns in regard to the ERA's conclusions on cost of capital and the low rate of return that the Draft Decision provides for the next access arrangement period. ENA also considers the returns allowed by the ERA to be insufficient to ensure stable and efficient investment signals flows to Western Power. ENA is of the view that ERA should reconsider its decision on cost of capital with a view to its estimate in the final decision not introducing distortions and divergence of investment incentives across Australian energy networks.

Furthermore, ENA is also concerned with ERA's Draft Decision to disallow recovery of taxation costs associated with forecast capital contributions and gifted assets. Such a decision will create disincentives for investment in Western Power network compared to network businesses that operate in other Australian jurisdictions where taxes on capital contributions are recovered through revenue allowances. ENA considers that, to the extent that capital contributions and gifted assets are used to provide regulated services, the tax costs should be recovered from the regulated revenue, as is the common regulatory practice in eastern Australian states and territories.

ENA addresses each on these issues in the following sections of this submission.

Approach to operating cost assessment

ENA is concerned with the lack of robustness of the framework applied by the WA Economic Regulatory Authority in developing alternative operating cost forecasts made under the *Electricity Networks Access Code*. ERA have applied a range of alternative techniques to derive an alternative forecast, including: a 'line item' level reduction to forecasts on the basis of engineering expert advice, revised labour and material input cost indices, high level 'top down' partial factor benchmarking approaches, and the application of scope and scale efficiency factors.

In addition to these techniques, the ERA has also used a 'base year roll forward' approach relying on incentives present in the prior access arrangement period. In setting forecast operating expenditure, the ERA has further applied a two per cent compounding operating efficiency assumption. This assumption appears to be based on a broad conclusion of the ERA's external consultants. It is unclear on what empirical basis it has been derived. ERA appear to be considering the issue of the level of this operating efficiency assumption by primarily weighing this conclusion against a broad target for desired operating efficiencies from a wide range of government trading enterprises set by the WA state government.

ENA considers that forecasts which effectively combines a range of approaches without clearly articulating their relationship to each other risks failing to meet the clear criteria in Clause 6.4 of the Code in relation to forecasts reflecting the forward looking costs of an efficient service provider. The reduction of forecasts based on adjustments to reveal base year expenditure, which is assumed to be a reflection of the operation of existing incentives, when combined with outcomes justified by high level 'top down' benchmarks which fail to take into account relevant network characteristics, and a broad undocumented assumption about likely potential efficiency gains, risks delivering a forecast that has no transparent or rational basis. This is because the forecast involves 'double counting' and effectively risks assuming that all efficiency gains identified by the technique or assumptions are additive in nature, where this is extremely unlikely to be the case.

Cost of capital

A real post-tax 'vanilla' cost of capital of 3.87 per cent[1] (or nominal post-tax WACC of 6.52 per cent) determined by the ERA in its Draft Decision is significantly below that allowed to network service providers elsewhere in Australia. ENA has strong concerns that such a regulatory allowance for cost of capital will not be sufficient to deliver efficient investment signals for Western Power's network or adequately recognise the opportunity cost of capital.

ENA observes that the ERA's conclusions on cost of capital differ markedly from those reached by the Australian Energy Regulator (AER) in its final decisions for the Powerlink Electricity Transmission Network and the Aurora Electricity Distribution Network that were released in March 2012. In these decisions, the AER determined a nominal post-tax rate of return of 8.61 per cent for Powerlink[2] and 8.28 per cent for Aurora.[3] ENA considers that even this rate of return provided by the AER is not sufficient to attract an appropriate level of investment in energy networks infrastructure in light of current market conditions.

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[1] ERA *Draft Decision on Proposed Revisions to the Access Arrangement for the Western Australia Power Network*, March 2012, p.207.

[2] AER *Final Decision: Powerlink Transmission Determination 2012-13 to 2016-17*, April 2012, p.33.

[3] AER *Final Distribution Determination for Aurora Energy 2012-13 to 2016-17*, April 2012, p.29.

In its Draft Decision, the ERA determined cost of capital parameters that are significantly different from those proposed by Western Power and those which generally apply to Australian energy network businesses. Key aspects of the rate of return approach in the Draft Decision include:

- Adoption by ERA of a 5-year term to maturity assumption for estimating risk free rate and debt risk premium instead of 10-year term to maturity commonly adopted in Australian regulatory practice;
- The application of a bespoke 'Bond Yield' approach for estimating debt risk premium instead of extrapolation of the fair value estimates published by private financial agencies;
- The adoption of an A- credit rating instead of BBB+ proposed in common usage in Australian energy network regulation;
- The application of a 'spot' risk free rate during a period of historically low yields on benchmark Commonwealth Government Securities without a countervailing adjustment to the historically-based market risk estimate, failing to recognise the well-accepted inverse relationship between the two parameters; and
- An equity beta assumption lower than is supported by regulatory precedent across the Australian energy network sector.

The approach used by the ERA results a nominal post-tax return on equity of 7.57 per cent.[4] This means that Western Power would need to implement its investment program with prospective rates of returns significantly lower than those allowed in most other jurisdictions. ENA considers the ERA's allowed return on equity does not reflect the underlying risks of providing regulated services and may result in inefficient deferral of investment into future access arrangement periods to the cost of current and future consumers.

ENA is concerned with the ERA's Draft Decision on the equity beta. ENA is of the view that the ERA should take a conservative approach to equity beta given the uncertainties surrounding its empirical estimation. These uncertainties were partially recognised by the AER in setting its equity beta estimate of 0.8. In addition, Western Power is arguably exposed to higher non-diversifiable risk when compared to businesses that operate in the National Electricity Market, because of the requirement under the *Electricity Network Access Code* to undertake *ex post* assessment of incurred capital expenditure before it can be included in its capital base.

ENA understands that it is the ERA's opinion that such a risk is firm-specific in nature, and should not be compensated through equity beta. In this area as well, the ERA adopts a position at variance with nationally-based regulatory approaches. The AER, for example, specifically addressed this issue in the 2009 WACC review. In particular, the AER suggested that 'utilities face a lower degree non-diversifiable business risk', which is partially due to the protection provided by the regulatory regime, such as a requirement to roll forward regulatory asset base without an *ex post* prudency assessment.[5] It follows that the AER clearly considers exposure to non-diversifiable risk to be affected by the nature of the regulatory regime. In this regard, ENA concurs with the AER and is of the view that such a risk should be taken into account when setting a value of equity beta.

[4] ERA *Draft Decision on Proposed Revisions to the Access Arrangement for the Western Australia Power Network,* March 2012, p.206.

[5] AER *Final Decision: Electricity transmission and distribution network service providers, Review of the weighted average cost of capital (WACC) parameters*, May 2009, p.249.

Another matter of concern with the ERA's Draft Decision on cost of capital is its estimation of the debt risk premium. The ERA's credit rating analysis in Table 71, complemented by observation of a stand-alone credit rating for Synergy electricity retailer (which is not considered to be an appropriate comparator for a network service provider), does not provide sufficient evidence to justify a departure from the previously adopted credit rating assumption (BBB+) towards a higher credit rating (A-).[6] ENA also does not agree with the view that a 5-year term to maturity better reflects financial strategies of an efficient network service provider. It is broadly accepted that network businesses in fact prefer to issue longer term debt in order to minimise refinancing risks. Following the onset of the GFC network businesses did issue debt of a shorter than benchmark term to maturity, however it does not mean that the benchmark need to be adjusted as this was a reflection of market conditions and the effective closure of some segments of the debt market.[7] ENA considers that the ERA should fundamentally reconsider its Draft Decision on cost of capital. In doing so, the ERA should have regard to the rates of return adopted in other jurisdictions, the need to promote certainty and consistency over the cost of capital parameters and methodologies and avoid the adverse outcomes associated with underestimation of the rate of return allowance.

Capital contributions

In its Draft Decision, the ERA disallowed Western Power the recovery of $240.5 million of net tax costs associated with forecast capital contributions and gifted assets. ENA is concerned that such a significant amount will not be recovered through regulated revenue, creating disincentives for future investment in Western Australia.

Under the existing arrangements, the value of capital contributions and gifted assets is not included in the capital base. Therefore, the regime does not provide for return on and return of capital associated with the contributed assets, preventing customers from paying twice for them. However, the capital contributions are treated as revenue for taxation purposes and Western Power incurs additional tax costs associated with these assets. ENA considers that the regulatory regime should provide for the recovery of these additional costs through the taxation building block.

The ERA's Draft Decision considered that, as customer contributions do not form a part of regulated revenue, it would be inconsistent to include the taxation costs associated with these contributions in the revenue requirement. ENA disagrees with this position. ENA considers that, to the extent that capital contributions and gifted assets are used to provide regulated services, the tax costs should be recovered from the regulated revenue in the same manner as for any other assets used for provision of reference services.

ENA is also concerned that the ERA's decision on the taxation of capital contributions will provide disincentives for future investment in Western Australia compared to other jurisdictions. This is because other regulators, including the AER, commonly provide allowances for capital contribution when calculating business' tax liabilities. The energy network asset owners in other jurisdictions therefore do not face penalties associated with taxation on capital contributions, making them more attractive for investors.

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[6] NERA Economic Consulting and PWC, *The Debt Risk Premium Benchmark and its Measurement - A joint report for the Energy Networks Association*, April 2012, p.12.

[7] NERA Economic Consulting and PWC, *The Debt Risk Premium Benchmark and its Measurement - A joint report for the Energy Networks Association*, April 2012, p.5.

If you have any questions, or ENA can be of further assistance in developing IPART's views on these important issues, please contact Garth Crawford, Principal Advisor, Economic Regulation on 02 6272 1555.

Yours sincerely

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Malcolm Roberts
Chief Executive