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Mr John Pierce
Chairman
Australian Energy Market Commission
PO Box A2449
SYDNEY SOUTH NSW 1235

Dear Mr Pierce 

ERC0143 – VALUE OF GAMMA

The AER welcomes the opportunity to provide this submission on the rule change requests submitted by ElectraNet and SP AusNet. In summary, the AER does not consider that the proposed rule changes meet the rule making test set out in the National Electricity Law.

In 2006, the AEMC put in place a framework for the determination of Weighted Average Cost of Capital (WACC) parameters to be applied to transmission network service providers. This framework was developed through extensive consultation and was deliberately designed to trade-off flexibility with creating a certain investment environment.

As has been noted by the AEMC, the issue of the appropriateness of this framework for future regulatory decisions is being considered through a separate process. The AER has submitted a rule change proposal that would increase the flexibility for the initiation of a periodic WACC review. In addition, the statutory review of the Limited Merits Review framework has also been brought forward to be considered alongside the AEMC's consideration of the rule changes proposed to the economic regulatory regime. These reviews are capable of addressing the issues raised by the rule change proponents for future regulatory decisions.

While these rule changes have been proposed to fix what has been portrayed as an 'anomaly', the Chapter 6A framework is operating as was intended in that all parameters are to be considered as part of a single WACC review.

The rule change seeks to adopt a single Australian Competition Tribunal outcome, while leaving all other parameters constant. This includes the market risk premium for which the Tribunal has recently upheld an AER decision of 6 per cent, as compared to 6.5 per cent determined during the WACC review. Therefore, even if it were accepted that the appropriate gamma value is 0.25, the AEMC can have no confidence that the quality of the overall rate of return estimate is improved by this rule change request.

Therefore, in terms of the questions raised by the AEMC, it is not possible to be definitive on whether the results of this selective alteration to the transmission WACC determination would likely lead to an over-recovery of the efficient costs, or provide skewed incentives for investment. Such an assessment could only be made through a re-consideration all of the constituent components of the rate of return.

The appropriate way to address this issue is through a review of all parameters at the appropriate time. The AER acknowledges that more flexibility is required for the initiation of such reviews. Further, the AER does not have any in principle objection to the expansion of the merits review framework to cover the WACC review as is available to the other elements of a regulatory decision (such as capital and operating expenditure forecasts).

However, departing from the previous WACC review in respect of one discrete parameter does not provide any greater certainty that the objective of promoting investment in, and efficient use of, electricity services for the long term interests of consumers will be achieved. The proposal therefore does not meet the statutory rule making test.

The AER notes that in 2008 a similar rule change proposal was considered and rejected by the AEMC on the equity beta and gamma values. On that occasion the Energy Users Association of Australia sought to prescribe an equity beta of 0.75 and a gamma of 1.0. In rejecting the proposal the AEMC concluded:

“The parameters review, to be conducted every five years by the AER, is the most appropriate process to determine the best estimate for the revenue determination parameter values. The Rules specify parameter values to provide certainty and a stable investment climate for those determinations which commence before the completion of the first AER parameters review.”¹

It is also instructive to consider the arguments put forward by NSPs and their representative organisations through the 2008 rule change process. As summarised by the AEMC:

“A number of submissions argued against this. Grid Australia considers that the EUAA argument for not also considering the market risk premium as underlining the ad hoc and partial nature of its Rule change request and that the EUAA has offered no reason as to why the market risk premium should be estimated with apparently less precision than the equity beta. The ENA comments that the Rule change proposal would prevent the AER from being able to examine the cross-linkages between the equity beta and gamma values

¹ AEMC 2008 Final Rule Determination - Parameter Values, Equity Beta and Gamma, pg 9

and other parameters which fall outside the scope of the EUAA Rule change proposal.”²

The AER considers that these arguments remain valid. On this basis, the AER does not support the proposed rule change.

If you or your staff would like to discuss any element of this submission, please contact Ross Mitchell on 02 9230 9127.

Yours sincerely



Andrew Reeves
Chairman

² Ibid pg 17