15th March 2013

Review of the method for determining WACC
Independent Pricing and Regulatory Tribunal
Level 8, 1 Market St
Sydney, NSW

Submitted online at: www.ipart.nsw.gov.au

Dear IPART

Response to the IPART Discussion Paper - Review of method for determining the WACC

1. Introduction

EnergyAustralia welcomes the opportunity to make a submission to IPART on the Discussion Paper: Review of method for determining the weighted average cost of capital (WACC) (Discussion Paper).

EnergyAustralia is one of Australia’s largest energy companies, providing gas and electricity to over 2.7 million household and business customers. EnergyAustralia owns and operates a multi-billion dollar portfolio of energy generation and storage facilities across Australia including coal, gas and wind assets with control of over 5,600 MW of generation in the National Electricity Market.

Since early 2011, we have been the Standard Retailer in the greater Sydney region for electricity and have been retailing to NSW electricity and gas customers from the introduction of the contestable market. We currently supply 1.1 million electricity and 0.26 million gas customers in NSW.

In our recent submission to the IPART review of the regulated retail prices and charges for electricity 2013 to 2016 (Electricity Review), we engaged Deloitte to comment on the WACC relevant to electricity generation and retailing.¹ We continue to support the views outlined in that submission.

While all methodologies should undergo a periodic review, we understand that the need for this review as the global financial crisis has had a significant impact on a wide range of financial data. Relying on the existing methodology could therefore lead to unexpected or anomalous estimates of the WACC.

2. Consistency of approach between industries

This current review only examines certain aspects of the WACC methodology used by IPART in making regulated pricing determinations and in the main touches on different questions than included in the Electricity Review. However, we are unsure how some of the findings of this review will be applied to the WACC being determined in the Electricity Review and explore these issues below.

¹ EA, Submission to the IPART review of regulated retail prices and charges for electricity 2013 to 2016 (Electricity Review), Jan 2013
2.1. Application of regulatory principles

In the Discussion Paper, IPART note that in establishing a methodology for the WACC there is a need to ensure that the method is ‘consistent with the broader principles of regulation’ and therefore should be:

- transparent
- predictable
- consistently applied over time and between utilities
- no more complex than necessary

While this sounds generally sensible, we question the need to make the method consistent between utilities from different industries, if this is what is intended.

IPART observed in the Discussion Paper, ‘many of the utilities IPART regulate are owned by the NSW Government’. This is no longer true of the NSW energy generation and retail sector. In other reviews, IPART has stated that there are differences between the competitive electricity retail/generation industry and other more heavily regulated utilities such as electricity networks and the water industry, which typically have regulated asset bases and face a much different set of market conditions.

In commenting on how the WACC approach may alter for different industries, IPART noted in the ‘all industries’ review of the approach to estimating the debt margin in 2011:

> We assigned a different value for the equity beta and gearing to recognise differences between electricity retailing and generation, versus the benchmark network business and to recognise the risks specific to the electricity retail and generation sector. We will consider whether the benchmark network assumptions are relevant to electricity retail and generation in future reviews for this sector.

IPART also commented in the draft methodology paper for WACC for the Electricity Review that:

> However, our current approach in other industries has changed from a 10-year to a 5-year term-to-maturity, which approximates the regulatory period. ... However, the reasons for changing our approach to a 5-year term-to-maturity may not be relevant to many of the businesses for which we need estimates of the WACC (such as unregulated electricity generation and retail businesses and gas supply businesses).

These comments show that IPART have contemplated taking a different approach for the energy generation and retail sector. We believe that it is necessary for IPART to alter the methodology to suit particular industries.

2.2. Post-tax WACC

We note that this ‘all industries’ review assumes a post-tax WACC approach. This would represent a change to the approach used in regulated electricity price reviews in the past, which have calculated the WACC on a pre-tax basis.

In our submission to the Electricity Review, Deloitte outlined that for retail electricity businesses it may be difficult to apply a post-tax WACC methodology. The pre-tax approach to WACC is well-established for electricity reviews and we request that IPART consider whether changing to a post-tax approach would be beneficial overall given that it could lead to a reduction in regulatory certainty. Nonetheless,

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2 IPART, Discussion Paper, page 13
3 IPART, Developing the approach to estimating the debt margin review, Final Decision, Apr 2011, page 11
4 IPART, Incorporating a return on capital in the 2013 electricity determination, Draft Methodology Paper, Nov 2012, page 7
5 EA, Submission to the IPART Electricity Review, Appendix A, pages 2-3
we would welcome further discussion of the potential issues in applying a post-tax methodology to an industry in which regulatory outcomes are determined without reference to a regulated asset base.

2.3. Summary

We urge IPART to consider continuing to using a 10-year term-to-maturity when estimating the risk free rate for reviews in the competitive energy generation and retail sector. In addition, we are yet to see any compelling reason why it would be better to move to a post-tax approach when estimating the WACC for our industry.

3. Elements under review

3.1. Estimating the cost of debt

In the previous ‘all industries’ review on the debt margin component of the WACC methodology, we submitted that for the electricity generation and retail sector:

- the length of the regulatory period has no bearing on funding practices;
- the revenue and cash flows from these industries are less dependent on regulatory determination; and
- we provided further (confidential) evidence to show that some recent transactions in the US private placement market had a weighted tenor (at issue) of 12 years and were using several other short and medium term debt instruments at the time.

While using a 5-year term may not be unreasonable for estimating the debt margin of the retail component, it is more appropriate to use fixed income securities with a 10-year tenor for the generation business to better align with asset lifetimes and prudent financing strategies.

3.2. Estimating the cost of equity

Risk free rate and the market risk premium (MRP)

In terms of the cost of equity and debt, we recently included a report from Deloitte in our recent submission to the IPART Electricity Review and commented on our preferred approaches to estimating the cost of equity for electricity generation and retail businesses. We stand by the points made in this submission.

The approach used by IPART for the risk free rate should be considered in such a way that is consistent with the estimation of the market risk premium (MRP). As Deloitte noted in the submission to the Electricity Review:

> 'The MRP is highly sensitive to the different choices associated with the measurement period, risk free rate and averaging approach used and as a result, estimates of the MRP can vary substantially.'

Capital Asset Pricing Model (CAPM)

We support the continued use of the CAPM over the other models outlined by IPART in the Draft Methodology Paper. CAPM is a widely used and well-understood model and provides more regulatory certainty than the other models considered by IPART.

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6 EA, Submission to the IPART Electricity Review, Appendix A, page 3
7 EA, Submission to the IPART review: Developing the approach to estimating the debt margin, March 2011, pages 1-2
8 EA, Submission to the IPART Electricity Review, Appendix A, page 5
3.3. Establishing the range and choosing the appropriate WACC value

Deloitte recently commented on some aspects of establishing a range and choosing an appropriate WACC value. Some of the main points on this topic included in our submission are: 9

- Where a range is selected for a given parameter, the range should be selected such that the likelihood of any point within the range be equal. Consequently, a WACC derived using the parameter ranges will also produce a range for the WACC and by selection, any point within the WACC range should have an equal likelihood of prevailing. IPART should therefore be indifferent between selecting between different points within the range.

- Selecting the mid-points of the range for each of the input parameters may not necessarily produce the mid-point of the WACC range. We note however, that if the principles discussed above are followed, any point within the WACC range should be equally likely which, in our view, would demonstrate internal consistency between the WACC inputs and the selected WACC.

- The parameters of the WACC are selected with reference to market observations. Consequently, when conducting an annual review of the WACC, our view is that it is necessary to review and update each of the WACC parameters, so as to ensure that the individual parameters are consistent with each other and that the overall WACC outcome is current.

4. Summary

It does make sense for IPART to review the WACC methodology at this time. The long-lasting impact of the global financial crisis on key financial metrics has led to less consistency between WACC parameters used in previous electricity determinations and this is not ideal.

Many of our comments on the IPART WACC approach have been captured in our recent submission to the Electricity Review as outlined above. Our major concern with this review is that it may seek inappropriately to impose a uniform WACC methodology across all businesses that IPART regulates. The energy retail and generation sector operates in a more competitive environment with an entirely different type of asset base and ownership than most other businesses regulated by IPART.

If IPART does seek to apply a common approach to determining the WACC across all industries, we would like IPART to provide their rationale in making that decision.

If you would like to contact me about this submission, please call me on (03) 8628 1242.

Yours sincerely

Melinda Green
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9 EA, Submission to the IPART Electricity Review, Appendix A, page 13