



22 July 2013

Jeremy Cook  
Economic Regulation Authority  
Level 4, Albert Facey House,  
469 Wellington Street, Perth WA 6000

Dear Jeremy

**CONSULTATION PAPER: REVIEW OF THE METHODOLOGY FOR SETTING THE MAXIMUM RESERVE CAPACITY PRICE AND THE ENERGY PRICE LIMITS IN THE WHOLESALE ELECTRICITY MARKET**

Alinta Energy (Alinta) appreciates the opportunity to provide a submission to the Economic Regulation Authority (the Authority) on its five year review of the methodology for setting the Maximum Reserve Capacity Price (MRCP) and Energy Price Limits (EPL) in the Wholesale Electricity Market (WEM).

We understand that any comments provided through this consultation process will be considered by the Authority as part of its comprehensive assessment of the methodologies. A more detailed consultation paper outlining specific recommended changes to the methodologies is expected to be published for further consultation with industry.

***Alinta's views***

Given the broadness of the scope of the Authority's five year review, Alinta has provided mainly high level suggested refinements to the methodologies in this submission. The suggestions provided are intended to assist the Authority's further investigation of whether any changes to the methodologies are warranted.

Also outlined in this submission are Alinta's recommendations that the Authority:

- investigates options for ensuring greater capacity price stability; and
- considers the appropriateness of the current five yearly parameters for the Weighted Average Cost of Capital (WACC) used in determining the MRCP.

***1. Refinements to the current methodologies for MRCP and EPL***

To improve the efficiency and effectiveness of the current methodologies for setting the MRCP and EPL and the associated review processes, there are a number of potential refinements that should be investigated by the Authority. These include:

- for the EPL:
  - Implementing only one maximum energy price cap (i.e. based off the cost of diesel);
  - Reviewing the current minimum energy price cap (set at negative \$1000) to ensure it is set at an appropriate level and implementing a process for future review; and

- Reducing the frequency of reviewing the EPLs (including the minimum energy price cap) to three yearly, subject to regular CPI adjustments. There should also be an ability for the Independent Market Operator (IMO) to amend the values in extenuating circumstances such as significant fuel price changes.
- for the MRCP:
  - Providing greater certainty as to the scope of the IMO's five year review of the Market Procedure for setting the MRCP (which contains the MRCP methodology) and the Authorities five year review of the MRCP methodology (Clauses 2.26.3 and 4.16.9 of the WEM Rules).

Further details of Alinta views on the current methodologies and associated processes, along with more detail on the suggested refinements identified above, are outlined in Appendix A.

## ***2. Investigation of options for creating greater capacity price stability***

Greater price stability is vital for encouraging investment in the WEM. Therefore it should be a priority for the Authority to look into mechanisms that would achieve this. While Alinta acknowledges that the Authority intends to restrict the scope of the review of the MRCP to not include considering how the value feeds into the Reserve Capacity Price (RCP), it is difficult to distinguish any discussion of the MRCP from a wider discussion of the RCP and its role in encouraging investment in the WEM.

To the extent that the Authority considers appropriate, Alinta suggests that options for providing greater price stability and potential options to lock in a capacity price outside of the current auction mechanism should be explored. Alternatively an investigation of any options to enhance capacity price stability should be incorporated into the scope of works for any broader review of the WEM.

## ***3. Appropriateness of five yearly WACC parameters used in calculating the MRCP***

Alinta remains of the view that a significant economic event has occurred since the five yearly WACC values were last set, resulting in the resultant WACC used in the MRCP not reflecting real world conditions. Concerns with the continued applicability of nominal return on equity and equity beta were raised by Alinta its most recent submission on the 2013 MRCP determination.

Alinta appreciates the difficulties faced by the IMO in determining whether a significant economic event has occurred and the need to ensure stability of these parameters; it is however important that the WACC parameters reflect real world conditions and that significant changes in the economic environment are appropriately adjusted for. Given the MRCP's relationship with the RCP, significant inaccuracies in the value of the WACC parameters can ultimately impact on private sector investment (new and existing).

Alinta requests the Authority to consider the concerns raised in Alinta's previous submission that a significant economic event has occurred since the values were set (provided as Appendix B).

If you would like to discuss this submission further please contact me on 9486 3009.

**Fiona Edmonds**  
Wholesale Regulation Manager





## APPENDIX A: Alinta's response to the Authority's Consultation Paper

Area of report	The authority invites comments from stakeholders on...	Alinta views
EPL role in curbing market power (3.2)	Whether having a Max STEM Price and an Alt Max STEM Price is appropriate	With a view to further simplifying the EPLs, Alinta supports the Authority in further considering whether it may be appropriate to just have one max STEM price (based on the cost of diesel).
EPL role in curbing market power (3.2)	The appropriateness of having a minimum STEM Price and on setting this value at negative \$1000 in the rules with no process provided for the review of this value	<p>To provide certainty to generators as to the maximum price they may have to pay to stay on, particularly overnight, Alinta supports the retention of a minimum STEM Price. It is however unclear whether a price of negative \$1000 is appropriate in the WEM. Alinta suggests that as part of its current review the Authority should consider whether -\$1000 is an appropriate level for the minimum STEM price to be set at.</p> <p>Likewise it is inappropriate to specify a price cap in the Market Rules but not have a review mechanism defined. Alinta supports the Authority in considering an appropriate review mechanism for the minimum STEM price to be implemented into the Market Rules.</p>
Requirements under clause 6.20 (3.3.1)	Appropriateness of clause 6.20 of the Market Rules and on the requirements to conduct an annual review of the EPLs, particularly whether the IMO should be able to propose revised EPLs outside of the normal review cycle, in response to significant changes	<p>Alinta supports the Authority in further considering options for reducing the frequency of review of the EPLs. In particular, Alinta is supportive of Synergy's previous suggestion that the EPLs could be reviewed three yearly, subject to regular CPI adjustments occurring. Additionally, where a significant change occurs the IMO should be able to propose and consult on revisions to the EPLs outside of the normal review cycle</p> <p>Alinta considers that reducing the frequency of the</p>

Area of report	The authority invites comments from stakeholders on...	Alinta views
Requirements under clause 2.26 (3.3.2)	Appropriateness of regulatory oversight provided under clause 2.26 of the Market Rules and whether any amendments should be considered	<p>EPL review would promote greater allocative efficiency.</p> <p>Alinta considers that it is appropriate for a separate regulatory entity to have procedural oversight of the IMO's determination of the MRCP and EPL. To adjust the role of the Authority in the process (unless they were to become the entity that determines the values for the MRCP and EPL) would potentially create an unnecessary duplication of work.</p>
Issues with current EPL methodology (3.4)	Requirement for developing a Market Procedure for documenting the methodology the IMO uses and the process it follows in calculating the EPLs	<p>Clause 6.20.7(b) provides a high level formula to be used in calculating the Max STEM values. Further details of how each of the components of the formula are determined is not outlined.</p> <p>Alinta considers there would be merit in developing a Market Procedure outlining the methodology for determining the EPLs and the processes that are followed in calculating the EPLs.</p> <p>Developing a Market Procedure will provide greater transparency of the overall methodology and ensure that any changes to the calculations are subject to a consultation process (as the methodology would be contained within subsidiary legislation). It will also ensure significant variations in the methodology applied to calculate the max STEM price would not unintentionally arise between reviews, particularly if the review is conducted by a different consultant in the future.</p>
Issues with current EPL methodology (3.4)	Whether the Market Rules should be amended to extend powers to the IMO and the Authority to request operational data from Market Participants on a confidential basis to provide more accurate inputs to the modelling process	<p>Alinta does not consider there is a need for the IMO or the Authority to request operational data from participants and is strongly opposed to regulators being able to routinely acquire</p>



Area of report	The authority invites comments from stakeholders on...	Alinta views
	involved in calculating the EPLs	<p>confidential contract information from participants.</p> <p>The existing processes for determining the values to feed into the EPL formula, including the engagement of a consultant to provide advice on the relevant gas costs to account for, have become embedded and are widely accepted by industry. Additionally if only one maximum price cap is used (based on diesel) then there will no longer be a need for gas price information, which is understood to be the information that the IMO and the Authority would be predominantly interested in obtaining for the modelling.</p>
Issues with current EPL methodology (3.4)	Whether the Market Rules should be amended to apply CPI indexing after the revised value has been in effect for 12 months regardless of when the anniversary of the review falls.	<p>Alinta supports the requirement for CPI adjustments to be made to the EPLs.</p> <p>In light of the recommended changes to the frequency of review, it may be appropriate to undertake a CPI adjustment every three months from the date that changes in inflation do not significantly impact on the continue appropriateness of the values .</p>
Issues with current EPL methodology (3.4)	Whether the Market Rules should be amended to reduce the frequency of the EPL review, and to apply other parameters such as carbon prices, CPI indexing and exchange rate changes to the calculation of the Alt Max STEM Price in between the reviews	Refer to above with respect to Alinta's suggested changes to the frequency of the EPL reviews.
MRCP Market Procedure (4.3.1.2)	Requirement for developing a MRCP Market Procedure under clause 4.16.3 of the Market Rules	<p>Alinta considers that there is merit in enabling existing and new investors to have transparency of the methodology for determining the MRCP and that any changes must be subject to a consultation process.</p> <p>As noted above, Alinta supports the introduction of similar requirement for a Market Procedure relating to the methodology and processes used</p>

Area of report	The authority invites comments from stakeholders on...	Alinta views in setting the EPLs.
5 yearly review of the MRCP procedure (4.3.1.5)	Appropriateness of the required five yearly review of the MRCP Market Procedure and whether the frequency of the review should be modified	Alinta is concerned that there may be some overlap between the Authorities five yearly review of the methodology (which is prescribed largely in the Market Procedure) and the IMO's 5 yearly review of the Market Procedure. Alinta recommends that the Authority considers whether any further clarifications to the specific scope of each of these reviews are required to ensure there is no unnecessary overlap in the future.
Approval process for MRCP value by Authority (4.3.1.6)	Appropriateness of the regulatory oversight provided under clause 2.26.1 of the Market Rules and whether any amendments should be considered	Refer above with respect to Alinta comments on the appropriateness of the Authority's role in providing procedural oversight in the determination of the MRCP and EPLs.
Franking credit value (4.4.7.8)	Appropriateness of the approach in classifying the gamma parameter as a five-yearly component and setting the prescribed value at 0.25 in the MRCP procedure	Alinta supported the IMO changing the specified franking credit value via PC_2012_08 rather than waiting for the next 5 year review, given the change was reflected in a number of Australian Competition Tribunal's decisions, including in May 2011, which we consider appropriately reflected a change in economic conditions.





19 December 2012

Mr Greg Ruthven  
Manager, System Capacity  
Independent Market Operator  
PO Box 7096  
Cloisters Square, Perth, WA 6850

Dear Greg

**DRAFT REPORT: MAXIMUM RESERVE CAPACITY PRICE FOR 2015/16 CAPACITY YEAR**

Alinta Energy (Alinta) appreciates the opportunity to provide a submission to the Independent Market Operator (IMO) on its Draft Report: Maximum Reserve Capacity Price (MRCP) for the 2015/16 Capacity Year.

This submission is intended to supplement the views put forward in January 2012 by Alinta on the Draft Report: MRCP for the 2014/15. In particular, Alinta continues to consider that a 'significant economic event' has occurred since PricewaterhouseCoopers (PwC) finalised its advice to the IMO and MRCP Working Group (MRCPWG) in February 2011 on the Weighted Average Cost of Capital (WACC) methodology. If anything, the evidence of a significant economic event is best illustrated by the recent market observations related to actual returns across a broad spectrum of securities. In particular there is a significant divergence between the rates for risky and non-risky assets in Australia:

- riskless securities such as government bonds have an artificially low rate as a result of foreign investors demand outstripping current supply; while
- risky securities such as bank debt have experienced an increasing cost of financing, as is evidence by the increased spread between bank borrowing and lending costs.

Consequently, Alinta continues to request the IMO to exercise its discretion under the Market Procedure for the determination of the Maximum Reserve Capacity Price (the Market Procedure) and re-examine the appropriateness of the prescribed five year values for the market risk premium (MRP) and equity beta used to calculate the WACC.

Alinta also requests the IMO to:

- reconsider whether the risk free rate of return being applied in the WACC continues to be appropriate given that government bond rates have been artificially reduced; and
- utilise bonds with a credit rating of only BBB in applying the ERA's bond-yield to ensure that the riskiness of investing in generation assets in the WEM is appropriately reflected.

Further details of Alinta's concerns are discussed in more detail in this submission.



## **Background**

### ***Purpose of the MRCP***

The primary purpose of the MRCP is to cap the price that may be paid by the IMO for capacity should a capacity shortfall arise. The MRCP reflects the estimate cost of providing new generation capacity in a future Capacity Year, and is calculated through a bottom-up evaluation of the forecast cost of constructing a new 160 MW Open Cycle Gas Turbine to enter the WEM during the relevant Capacity Year.

The MRCP is also used to derive the Reserve Capacity Price (RCP) for the WEM, an administered price that may be paid for capacity that is voluntarily made available to the IMO. Due to concerns around the inability of the RCP to adjust quickly to market conditions, a review of the formula used to determine the RCP has been undertaken by the Reserve Capacity Mechanism Working Group (RCMWG). Alinta anticipates that the IMO will progress a Rule Change Proposal to implement a proposed revision to the formula for setting the RCP during early 2013. Any resultant Amending Rules should be subject to a transition period given that the changed method may lead to material financial impacts.

### ***Revised Market Procedure***

The Market Procedure details the method and process to be followed by the IMO when annually determining the MRCP. Under the Market Rules the IMO is required to review the Market Procedure at least once in every five years. To this effect the IMO established the MRCPWG in May 2010 to consider, assess and develop necessary changes to the Market Procedure.

To assist the MRCPWG in its deliberations, PwC was engaged by the IMO to broadly review the appropriateness of the WACC parameters, including considering any changes in the regulatory environment that may require revisions to the methodology used to calculate the WACC.

The resultant revised Market Procedure commenced on 24 October 2011 and was applied by the IMO in setting the MRCP for the 2014/15 Capacity Year. Application of the revised methodology (which was not subject to a transition period) along with year-on-year variations in the input parameters, primarily for the WACC, resulted in a reduction in the MRCP of 31% (to \$166,100) from the value determined for the 2013/14 Capacity Year of \$240,600.

### **Proposed MRCP for the 2015/16 Capacity Year**

The IMO proposes a MRCP for the 2015/16 Capacity Year of \$157,500 per MW per year<sup>1</sup>, a reduction of 3.9% from the 2014/15 MRCP. The IMO notes that the most significant changes have been with respect to:

- Power Station Costs (3.7% lower) as a result of falling steel and copper prices coupled with the appreciation of the Australian dollar against the Euro;
- Fixed Fuel Costs (122% higher) as a result of Sinclair Knight Merz's (SKM) review of the estimate with the benefit of recent project experience in Western Australia; and

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<sup>1</sup> Note that this value is inclusive of the proposed change in the gamma variable used in the WACC from 0.5 to 0.25 which has been proposed under PC\_2012\_08. The proposed revision will ensure consistency with Australian regulators during the past 18 months and is supported by Alinta.



- WACC (reduction from 6.83% to 6.03%) driven by a further deterioration in government bond yields and use of the bond yield approach developed by the ERA for determining the debt risk premium.

In its submission on the MRCP for the 2014/15 Capacity Year, Alinta raised a number of concerns with the year-on-year variations being indicative of a “significant economic event” having occurred since PwC provided advice on the WACC methodology to the MRCPWG in February 2011.

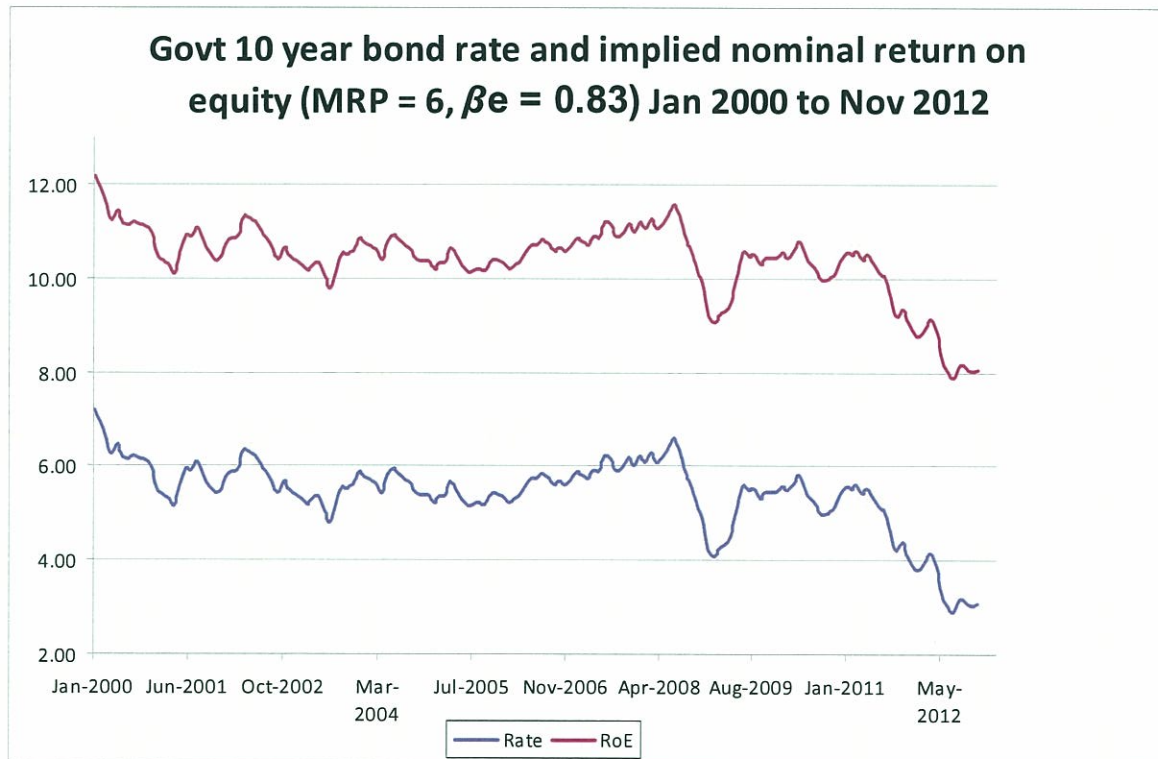
Evidence during 2012 continues to support this observation and is presented below. Additionally detail of Alinta’s other concerns around the cost of equity and debt risk premium applied in the WACC methodology are also provided.

**Issue 1. Low cost of equity used is not consistent with rational investor’s expectations**

The Market Procedure requires the cost of equity to be calculated using the CAPM, which multiplies the Market Risk Premium (MRP) by the equity beta, with the resultant product being added to the risk free rate.

In determining the proposed value of the MRCP for the 2015/16 Capacity Year, a nominal return on equity of only 8.11% has been used in accordance with the requirements of the Market Procedure. This represents a reduction of approximately 9% from the value of 8.9% that was applied in setting the MRCP for the 2014/15 Capacity Year. Further details of the continuing downward trend in the implied nominal return on equity, as determined in accordance with the Market Procedure, are reflected in Figure 1 below. Note that as the MRP and equity beta values are prescribed in the Market Procedure the predominant cause of the reduction has been from reductions in the rates for ten year commonwealth government bonds.

**Figure 1:**



Alinta does not consider that a rational investor would develop generation assets in the WEM for a return on equity of less than 12% and therefore questions the appropriateness of the values used in determining the return on equity. In particular, Alinta is concerned that the prescribed values applied for the MRP and equity beta are no longer applicable given recent stock market and electricity market experiences. Likewise Alinta considers that the risk free rate of return applied by the IMO in undertaking this review has been artificially deflated as a result of foreign investors placing downward pricing pressure on 10 year government bonds. These issues are explored in more depth in the following sections.

### Market Risk Premium

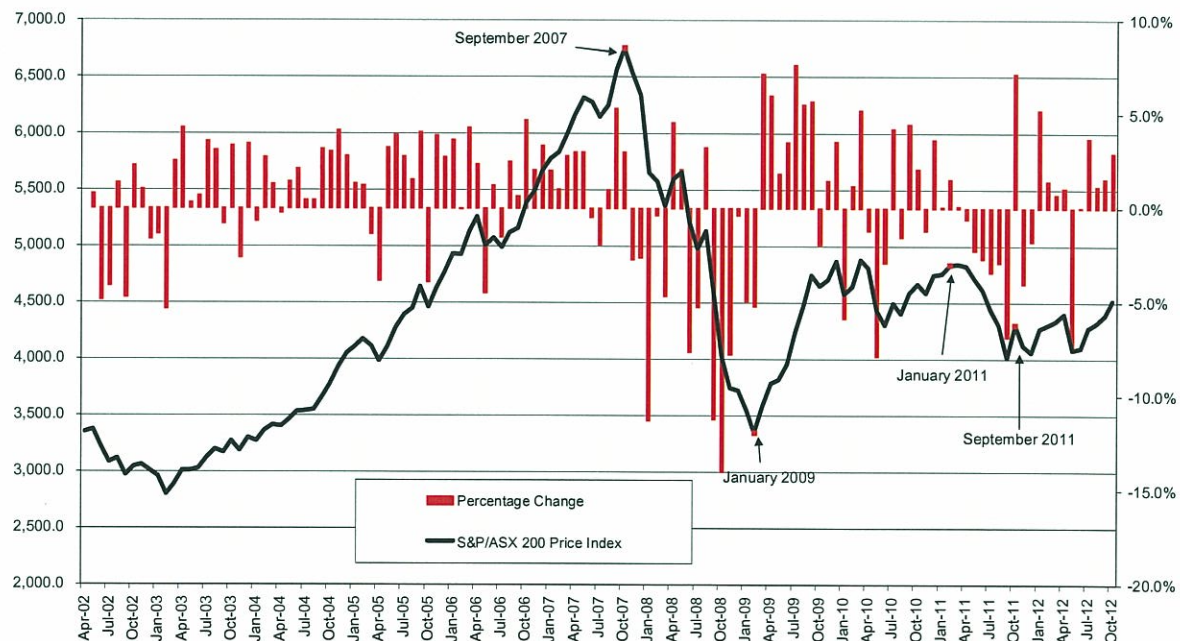
The MRP is the expected return over the risk free rate (compensation) that investors would require in order to accept average market risk.

In its final report for the MRCPWG, PwC (p. 24) recommended:

*“...a value for the MRP of 6.0 percent taking into account an emerging regulatory position for a revision to a long-standing position of adopting a MRP of 6.0 percent after contemplating a higher value of 6.5 percent for a period during and after the global financial crisis”.*

In its previous submission on the 2014/15 MRCP determination, Alinta raised concerns that given the increase in stock market volatility since the finalisation of PwC’s report a review of the MRP was required. This volatile behaviour has continued during 2012 as illustrated by Figure 2 below.

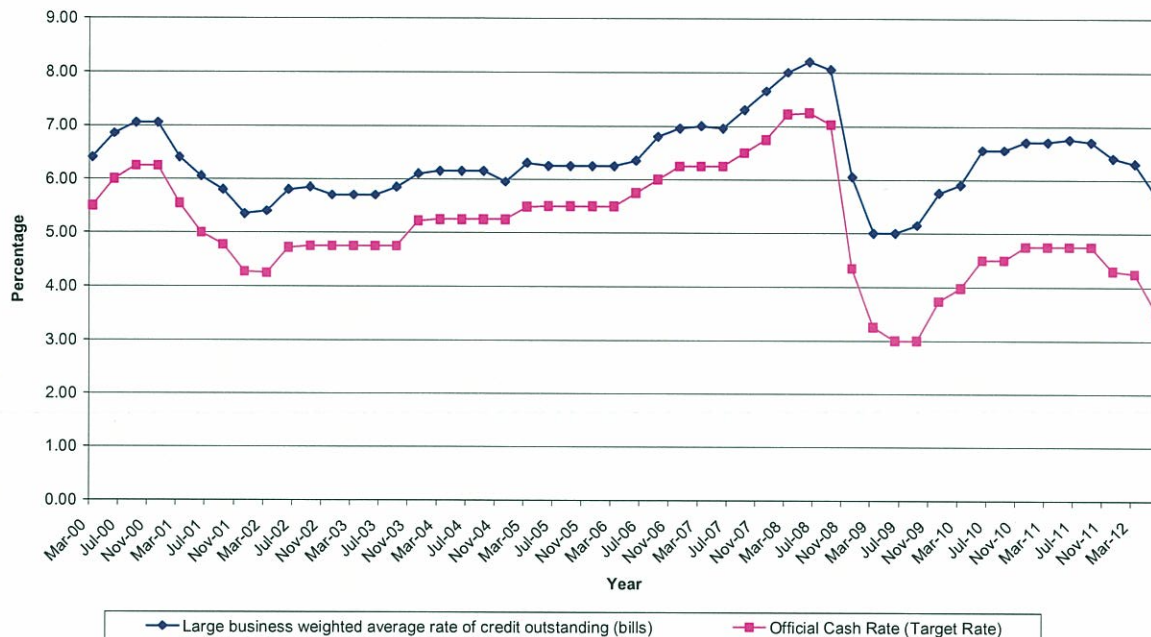
**Figure 2: ASX All Ordinaries Price Index**



Supporting the preposition that a “significant economic event” has occurred, Alinta also notes that there has been an increase in the divergence between the lending and borrowing rates of banks since March 2009. This is illustrated in Figure 3 below.



**Figure 3: Comparison of Bank Borrowing and Lending Rates from March 2000 - June 2012**



Given PwC's comments (noted above), it reasonably follows that investors expected MRP will also have increased from 6% given the occurrence of a "significant economic event" resulting in greater levels of investment uncertainty. Alinta notes that other electricity regulators have applied higher MRP's in recent years. In particular, following its 2009 review of the WACC parameters the Australian Energy Regulator (AER) has been applying a MRP of 6.5% to transmission and distribution network determinations as reflected in its guideline document. This includes for recent draft determinations such as for ElectraNet and Murraylink<sup>2</sup>. Alinta notes that the AER adopted a value of 6.5% "having regard to the desirability of certainty and stability".

Alinta recommends that in light of continued market evidence of a "significant economic event" having occurred and given that recent regulatory precedent of the AER, the IMO should consider adopt a MRP of 6.5%, as is applied by other regulators would be appropriate for determining the MRCP.

### Equity Beta

The equity beta measures the riskiness of the business relative to the overall market. It reflects the business's exposure to non-diversifiable risk. The equity beta value was reviewed in 2011 by PwC (who proposed a lower value on 0.77 along with a gearing of 35%<sup>3</sup>) and is based on 28 Australian and internationally listed generation businesses.

During the past four years electricity generators have experienced far more volatility than the market as a whole. This is evidenced by the recent significant reductions in electricity demand in the eastern states that have occurred in isolation from a reduction in economic growth. Likewise in Western

<sup>2</sup> Alinta notes that under rule 6A.2.3 of the National Electricity Rules guidelines are not mandatory and the AER can apply a different MRP value if there are reasons for departing from those values reflected in the guidelines.

<sup>3</sup> The MRCPWG decided to not adopt the recommendation to amend the gearing ratio or equity beta as proposed by PwC. Refer to Meeting 7: <http://www.imowa.com.au/MRCPWG>

Australia actual demand for energy has not been as high as was originally predicted given that a number of large new loads that were assumed in the Statement of Opportunities did not eventuate. Other factors resulting in volatility in the WEM include:

- significant variations in the Reserve Capacity Price that have created significant concerns for investors around expected returns on both new and existing generation assets;
- the impact of a Demand Side Management (DSM) on the Reserve Capacity Price, i.e. significant entry of DSM into the market over the last few years has contributed to an oversupply of capacity;
- significant cost to Market Generators of operating in the new Balancing and Load Following markets;
- increases in the penetration of renewable energy technologies have resulted in reduced overnight prices which have on occasions caused base load facilities to turn off over night and have changed requirements for Ancillary Services;
- uncertainty created by the Rule Change Process;
- lack of investment by the private sector in recent times in the WEM except in joint venture with Government, e.g. Vinalco, Mumbida windfarm, Greenlough River Solar Farm.

Given the volatility in the operating environment for electricity generation assets in Australia and specifically Western Australia, Alinta considers that the current value for the equity beta is inappropriate and resulting in a “non-real world” WACC outcome. Even at the assumed gearing levels, an equity beta of less than one does not adequately reflect the volatility in expected returns and therefore the relative riskiness faced by a standalone generator in Western Australia. An equity beta of less than one may be appropriate for an existing state owned base load generator however the risk profile is significantly greater for a privately funded new entrant electricity generator<sup>4</sup>. As the MRCP based on the development of a new 160MW Open Cycle Gas Turbine, Alinta considers it is appropriate to assume the higher risk profile would apply.

While the overall impact on the nominal return on equity is as a result of a combination of parameters, including the risk free rate of return and MRP (both discussed in this submission), Alinta considers that the IMO should engage an economic consultant to re-examine the equity beta given that it does not adequately reflect the riskiness of investment in a generator in the WEM.

### ***Risk Free Rate of Return***

The risk free rate represents the rate of return on an asset with zero default risk and is a key component of both the cost of equity (through the CAPM) and cost of debt.

In its submission on the MRCP for the 2014/15 Capacity Year, Alinta noted evidence of a “flight to quality” stemming from the continued economic uncertainty and share market instability leading to greater demand, and reduced yields, on Commonwealth Government bonds given the perception of Australia as a low risk economy.

The Commonwealth Government bond rate has continued to fall during 2012 as is illustrated in Figure 4 below. An analysis of the data indicates the following:

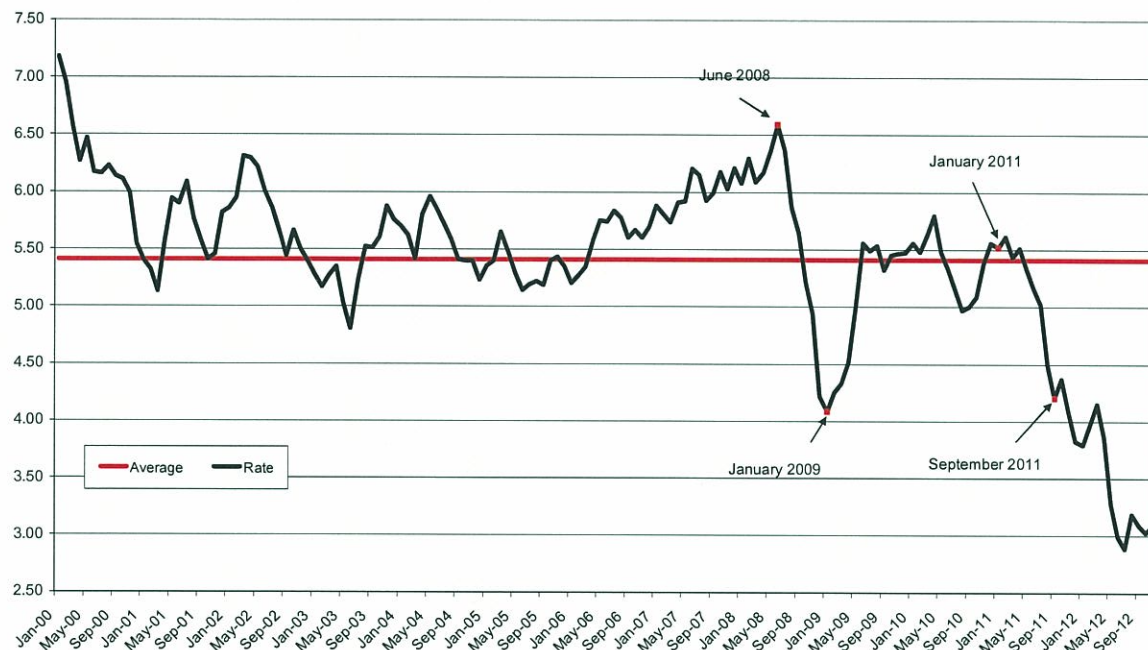
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<sup>4</sup> Refer to section 7.3 of the Energy Market Authorities Review of the Parameters for setting the vesting price for the period 1 January 2010 to 31 December 2010:  
[http://www.ema.gov.sg/media/com\\_consultations/attachments/1252902213LRMC\\_consultation\\_report\\_26\\_Jun\\_09\\_.pdf](http://www.ema.gov.sg/media/com_consultations/attachments/1252902213LRMC_consultation_report_26_Jun_09_.pdf)



- The long-run average monthly 10-year government bond rate, the “risk free rate”, over the period January 2000 to November 2012 was 5.4 percent. This average has been further depressed by the low bond yield values that have occurred since December 2011<sup>5</sup> and is lower than the bond rate in January 2011 when PwC finalised its advice to the MRPCWG.
- The actual monthly 10-year government bond rate was 2.89 percent in July 2012, though has risen slightly to 3.09 in November 2012. These values are the lowest in the data series.

**Figure 4: RBA Published Monthly 10-Year Government Bond Rate**



The continued reductions in the government bond yields have resulted in a reduction in the nominal risk free rate of return applied in determining the WACC by 20%, from 3.92% to 3.13%, since determining the MRCP for the 2014/15 Capacity Year.

In its Final Report to the MRPCWG (pp 20-21), PwC noted that:

*“...during the global financial crisis the convenience yield (measured as the difference between the yield on 10 year Commonwealth Government Securities and the 10 year Credit Default Swap) rose to 120 basis points, which was 76 basis points higher than the historical relationship measured over the period from 1991 to 2010. In these circumstances, **an adjustment to the risk free rate was potentially justified.** However, the current differential between the yield on 10 year Commonwealth Government Securities and the 10 year Swap yield is now close to the historically average differential (Figure 4.1). As such, it appears that the distortion of the market for Government bonds during the period of the global financial crisis has diminished.”* (emphasis added).

Alinta is concerned that the application of the risk free rate based on the current abnormally low yield on ten year Commonwealth Government bonds does not reflect the true risk free rate but rather is inappropriately depressed compared with its long run average value. Additionally, Alinta notes that once committed the development of generation assets are naturally long term investment decisions

<sup>5</sup> In January 2012 when Alinta prepared its submission on the MRCP for the 2014/15 Capacity Year the long-run average was 5.56 percent.



(30-40 years). The development of an asset such as a power station is very costly and requires significant certainty and stability of returns. Investors traditionally look to the capacity price to provide this certainty given the restrictions on bidding in the energy market (i.e. price caps and SRMC bidding requirements).

Alinta continues to request that the IMO seek advice from an economic consultant to confirm whether:

- global structural imbalances have created an excess demand for Commonwealth Government Bonds which have subdued their observed price, thereby justifying an adjustment to the risk free rate; and
- longer term, the observed yield on government bond remains an acceptable proxy measure of the risk free rate.

***Issue 2. Uncertainty around appropriateness of use of the ERA's bond yield approach in determining the Debt Risk Premium for a generation asset.***

In determining the WACC for a Capacity Year, the Market Procedure requires that the nominal return on debt be calculated as the risk free rate plus a debt risk premium plus an allowance for debt issuance costs. The implicit assumption is that the developer of the new generation facility would issue bonds into the corporate bond market to finance the debt component of the project.

The IMO is required under the Market Procedure to determine the methodology to estimate the debt risk premium, which in the opinion of the IMO is consistent with current Australian accepted regulatory practice. Following the Australian Competition Tribunal's decision to uphold the bond-yield approach applied by the ERA in its final decision on WAGN<sup>6</sup>, the IMO now considers that this approach is accepted regulatory practice and therefore has adopted it for determining the WACC.

Alinta supports the use of the ERA's bond yield approach for the purposes of determining a WACC for an electricity generation business. However, Alinta considers that using an investment grade rating of BBB+ is inappropriate for generators in the WEM. The debt levels and riskiness of servicing that debt for electricity generators is significantly greater than for network generation businesses. Further, during the past few years' significant financial problems have been experienced by a number of the Market Generators in the WEM. Given recent experience Alinta questions whether any generators in the WEM (and more broadly Australia) currently have a BBB+ investment grade rating (or even a BBB investment grade rating). Alinta requests the IMO to undertake an assessment of the ratings of independently owned electricity generators in Australia to confirm an appropriate investment grade to be used for the purposes of the ERA's bond yield approach.

## **Conclusion**

Given the evidence that has emerged since the finalisation of PwC's advice in February 2011, Alinta considers that it is clear that a significant economic event has occurred. This provides the basis for the IMO to exercise its discretion to determine alternative values for the MRP and equity beta values in the Market Procedure. Subsequently, Alinta requests that the IMO initiate another review of the Market Procedure to consider the values for these parameters.

It is important that the MRCP accurately reflects the complete and total cost and risks (regulatory, policy, economic and commercial) of developing a 160MW OCGT in the WEM given the MRCP's

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<sup>6</sup> Final Decision on WA Gas Networks Pty Ltd proposed revised access arrangement for the Mid-West and South-West Gas Distribution System.



important and vital role in setting the administered price where no capacity auction is held<sup>7</sup>. The issues highlighted by Alinta in this submission regarding the accuracy of the WACC have subsequent impacts on the accuracy of the MRCP. Alinta therefore recommends that the IMO:

- undertake a review of the MRP and equity beta prescribed in the Market Procedure.
- engage a suitable consultant to:
  - determine whether structural imbalances have artificially reduced the price of government bonds which means that an adjustment to the risk free rate is required; and
  - consider whether longer term the use of the 10-year yield on government bonds remains the best indicator; and
- only use bonds with a BBB rating when applying the ERA's bond yield approach.

Should you require any further information relating to Alinta's submission, please do not hesitate to contact me on 08 9486 3762. Alternatively you may contact Fiona Edmonds, Wholesale Regulation Manager on 08 9486 3009.

Yours sincerely

**Michelle Shepherd**

General Manager Regulatory and Government Affairs

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<sup>7</sup> While Alinta acknowledges that the primary role of the MRCP is to set a cap for the Reserve Capacity Auction an auction has not occurred since market start.