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Dr Duc Vo
Rate of Return Guidelines Review
Level 4, Albert Facey House
469 Wellington Street
Perth WA 6000

Dear Duc,

We welcome the opportunity to make this submission and to participate in the ERA's broader consultation process in relation to the formulation of its Cost of Capital Guideline. This letter is in response to the ERA's Draft Cost of Capital Guideline released on the 6th of August.

DUET was an active participant in the AEMC's National Gas and Electricity Rule Change process last year. We were encouraged by the AEMC's approach and by the balance they sought to strike between energy consumers' desire for lower prices in the short term and the longer term interests of consumers which are served by attracting investment capital to ensure the long term performance and growth of energy utility networks.

We and our security holders and lenders are looking to the ERA's Cost of Capital Guideline to provide investors with confidence in the stability and legibility of Western Australia's regulatory framework and faithfully to reflect the policy intent of the changes that were made to the National Gas and Electricity Rules last year.

DBP has prepared a detailed submission on the ERA Draft Guideline. DUET has been closely involved in the preparation of that submission and we endorse its conclusions fully. Some of those conclusions are summarised here, but we commend to you the more detailed discussion and analysis of the issues contained in DBP's submission.

From the perspective of an investor in energy infrastructure across a number of geographic regions and regulatory jurisdictions, we have a number of concerns about the ERA Draft Guidelines. We are of the view that these issues must be addressed if the Final Guideline is to provide a firm foundation for ongoing investment in energy infrastructure in Western Australia.

Consistency Across Regulatory Jurisdictions

DUET's interests are diversified geographically and across regulatory jurisdictions. In addition to our 80% equity holding in Dampier to Bunbury Pipeline (DBP), DUET Group owns 100% of Multinet Gas, a Victorian gas distribution business, and 64% of United Energy, one of five electricity distribution businesses in Victoria. We have previously held minority interests in WA Gas Networks (now ATCO Gas WA) and Duquesne Light, an electricity utility serving the city of Pittsburgh in the USA.

The ERA's approach to estimating the cost of capital as outlined in the Draft Guideline differs materially from the approach taken by the national regulator, the AER. While differences in approach are to be expected, any material difference in outcome is likely to result in a greater propensity for investment in one jurisdiction over the other as we ration capital in the group across our asset companies and as our security holders allocate capital between DUET Group and its listed peers in the sector with east coast utility businesses.

In this context, we are concerned at the impact of a lack of consistency between the ERA and the AER. For example, in relation to the term for risk free rates used to determine the cost of equity; if each regulator made use of a CAPM framework, and differed only in terms of allowing a ten year term in the risk free rate for equity costs on the east coast (the AER's preferred position) and a five year term for WA (the ERA's preferred position) the difference in WACC would be approximately 91 basis points (based on the 20 day average of the 5 and 10-year CGS as at mid-September this year). We submit that this would have a material effect on the attractiveness of investment in WA compared with the east coast.

DUET is proud of its record of investment in Western Australia and its contribution to the growth of our customers' businesses and to the economic development of the State. Together with our partner in DBP, Alcoa of Australia, we have committed over $1.8 billion of debt and equity capital to DBP since we acquired it in 2004. That investment has increased the capacity of the pipeline by more than 50%. Without this investment the growth in alumina refining capacity and the increase in gas-fired electricity generation capacity in WA over the last decade would not have been possible.

We understand that our business is critically linked to the future growth prospects for the south-west of the state and we look forward to continuing to make such investments based on a stable, predictable regulatory framework that encourages investment in critical long term infrastructure.

Consistency with National Policy

It is clear from the discussion accompanying the AEMC's decision on the National Gas and Electricity Rule changes last year that the AEMC intended that regulators take a different approach to estimating the cost of capital than they have in the past. In particular, the AEMC made it clear that regulators should take into account a range of methodologies and data in arriving at a cost of capital decision.

The AEMC Final Determination of November last year concluded that none of the rate of return frameworks previously employed by Australian regulators was capable of fulfilling the National Gas Objective or the Revenue Pricing Principles. This was a prime reason the AEMC gave for developing a new framework.

In its Draft Guidelines, the ERA has presented a framework which is essentially unchanged from its previous approaches; the very approaches the AEMC concluded were inadequate. This places the ERA's Draft Guidelines in the position of being inconsistent with national energy policy. Indeed, we are unsure whether DBP could follow the Draft Guidelines and meet the requirements of the new rules.

WACC Parameters

We accept that the ERA's preferred methodology, Sharpe-Lintner CAPM is, along with other approaches, an important consideration when estimating the cost of capital. However it, like all such methodologies, does not provide reliable results in all market circumstances and the reliability of the results is critically dependent on the use of sound empirical observation and analysis to estimate the input parameters. This is the primary reason why the AEMC gave regulators the flexibility to make use of other models; the same flexibility that is routinely applied by professional investment analysts.

Risk Free Rates and the Market Risk Premium

In previous submissions to both the ERA and the AER we have expressed our view that the use of 'spot' risk free rates in the CAPM formula is inconsistent with the use of long term averages for the Market Risk Premium. There are two valid alternative approaches to this issue: either the long term average MRP should be used with the long term average risk free rate or the 'spot' MRP should be used with the 'spot' risk free rate.

There is an inherent difficulty in taking the first of these two alternative approaches: the use of long term averages does not appear to satisfy the requirement in the National Gas Rules for the estimated cost of capital to be forward-looking. 'Spot' MRP, however, is notoriously difficult to observe empirically. Despite this difficulty, it is worthwhile to pursue the issue, as analysis of UK and US markets by, among others, Stephen Wright, concludes that equity returns are far more constant than market risk premiums over time. Dimson Marsh & Staunton, cited by the ERA, also reach similar conclusions, according to Stephen Wright, who cites their work in support of his own.

The ERA's conclusion that there was no 'flight to quality' following the global financial crisis is used as evidence to suggest that MRP is constant through the investment cycle is not supported by analysis undertaken by the Reserve Bank of Australia, simple observation and market experience, nor by the analysis undertaken by the AER in developing its Draft Guideline. This is expanded upon in more detail in DBP's submission, and in a submission from UED-Multinet, who note that the ERA's failure to consider flight of foreign capital into Australia may have skewed its results.

It is noteworthy that the AER, in its Draft Cost of Capital Guideline, has acknowledged these conclusions and has indicated that it intends to take into account in estimating the cost of capital, by making use of Stephen Wright's framework for assessing CAPM as one of the checks of its "fundamental model". Recognition of the relationship between MRP and risk free rates is critical to ensuring that CAPM delivers reliable conclusions about the cost of the capital.

As other regulators around the world have done, we consider it vital that the ERA examine the market risk premium afresh for periods of historically low interest rates to ensure that this does not produce further downward bias on rates of return and reduce investment.

Beta

We are concerned at the apparent reliance placed on observed listed betas in the ERA's discussion paper and the Draft Guideline.

Listed betas are, by themselves, not a valid basis to estimate beta for use in the CAPM. Corporate activity and specific commercial issues generally have the greatest effect on returns over the short-medium term and any underlying relationship between market returns and the performance of a specific company's securities is masked by these company-specific issues. In addition, uneven performance across market sectors (eg resources in Australia over the last 5 years) distort empirical observations of beta. In the Australian market the small number of companies in the utilities sector further frustrates statistically significant empirical analysis of listed betas.

The problems of statistical estimation of beta in the context of the small number of stocks in the ERA's sample is addressed in detail in DBP's submission which shows that, by making small changes to the methodology (like changing the day upon which returns are estimated), an analyst can produce a very large range of estimates of beta. This makes the regulatory methodology proposed by the ERA unworkable in practice. The only way to overcome these problems (which are caused by using the CAPM in the way the ERA proposes) is to make use of more data than just six firms in Australia and to make use of models other than the CAPM.

Assumed Term to Maturity for Risk Free Rates

We do not understand the ERA's reliance on observed average term to maturity of listed Australian utilities being used to inform the selection of an appropriate tenor for the risk free rate. As DBP points out, this appears to be based on inappropriate empirical and theoretical analysis, and is inconsistent with the approach taken by other regulators. As we note above, this makes a material difference to the attractiveness of investments in WA.

Utility assets are long life assets: in DBP's case much of the asset base has a useful life of 70 years. As such it is appropriate to fund these businesses, where possible, with long tenor debt facilities. To fund such businesses with short term debt is to increase the level of refinancing risk borne by equity investors.

By seeking to match the term of the risk free security to the average term to maturity of listed utilities the ERA is effectively eliminating the margin earned by investors for taking the additional financial risk inherent in the funding strategy. Such an approach would be valid only if the additional refinancing risk was recognised in a higher equity return, reflecting the resulting increased volatility of equity returns.

In the absence of explicit recognition of the impact of the additional financial risk inherent in funding long term assets with relatively short term debt by increasing beta, we suggest that the ERA should use the longest practical tenor for risk free rates, being 10 years.

Hedging Costs

We are of the view that the ERA has significantly underestimated the practical transition issues associated with its (tentative) proposal to adjust the cost of debt on an annual basis to reflect the trailing 7-year moving average of debt margins. The complexities of hedging our debt portfolio to match the regulated allowance for the cost of debt are not insurmountable, but they will take time to implement and will significantly increase hedging costs.

We also believe the ERA has significantly underestimated hedging costs; our understanding, from recent discussions with Westpac, is that hedging costs on a five-year debt would be around six basis points, not 2.5 as the ERA suggests. We would, in any case, urge the ERA not to define a numerical cost in its Guidelines, as these may change over time, but instead to define what sources of information it will deem acceptable in respect of these costs

We would, of course, welcome any further opportunity to discuss this submission or any of the more detailed supporting work submitted by DBP.

Yours Sincerely,

David Bartholomew
CEO DUET Group

cc Greg Watkinson
Chief Executive Officer