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2 February 2005

Mr Alistair Butcher
A/Director - Electricity Access
Economic Regulation Authority
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Dear Alistair

Comment on Proposed Weighted Average Cost of Capital for Western Power Corporation

Newmont Australia ("Newmont") is please to offer some comments on the Discussion Paper on the appropriate weighted average cost of capital (WACC) methodology to apply to Western Power Corporation's regulated electricity network in the South West Interconnected System.

The importance of selecting an appropriate WACC for application to Western Power's operations cannot be overstated. In our experience, the product of the Regulated Asset base and the WACC makes up over 50% of distribution charges and a much higher percentage of transmission charges. The selection of these two parameters by Regulators needs to be done carefully, if fair and reasonable network tariffs are to result.

WACC estimates in Australia are confused by the varying practices and assumptions made by the different Regulatory authorities. There are several different forms of the WACC formula, and results can be expressed in pre-tax or after-tax form, and in both real and nominal values. The treatment of tax can be quite varied, with tax excluded and treated as part of the cash flow of a utility at one extreme, or else assumed to be paid a nominal corporate tax rates, at the other. If a common approach cannot be agreed by all of the Regulatory authorities (a highly desirable position), then information should be provided which allows for a ready comparison of WACC values resulting in each Determination.

Providing a table based on the so-called "Vanilla WACC" on a post-tax and real basis, would provide a simple comparator, and is strongly recommended.

Based on advice that Newmont has received, the proposed level of 6.5% real and pre-tax, and assuming nominal corporate tax payments, is equivalent to 5.71% on a real, after tax basis using the "Vanilla WACC" formula. This involved recalculating the results presented in the report, and may be subject to error if we have not understood the report correctly.

If we are correct, it would seem that the recommended level is consistent with the range of recent determinations by regulatory authorities in Australia. The most recent precedents are that of the QCA in their Draft Determinations for the Dalrymple Bay Coal Terminal and the Queensland Distributors. We note that ERA has used the same consultant as advised the QCA.

This being said, Newmont still has some concern regarding elements of the calculation, although we acknowledge that it is the effect of all the assumptions taken together which needs to lead to an acceptable result. Our concerns relate to:

- the assumption of the Market Risk Premium (MRP). Although all Australian Regulators seem to assume a 6% value for the MRP, we are aware of considerable concerns expressed by some experts that this is based on outdated historical records; that MRPs have arguably declined in more recent times; and that its use based on historical and nominal vales may be inconsistent with the application of WACC to a revalued asset base.

- the choice of equity beta. It defies common sense that a regulated, Government-controlled entity operating as a monopoly provider of an essential service, should have a beta factor of one — implying the same level of risk as the average listed company. The evidence (and overseas practice) supports equity betas as low as 0.7, and we note that the QCA has adopted values of 0.8 and 0.9 in their most recent determinations.

- the treatment of tax at nominal corporate tax rates can be a problem. In theory, one should use an “effective tax rate” to reflect the fact that a utility may not pay tax at the normal corporate rate over a 5 year period, due to tax deductions available to it. As we understand it, this is the reason why the ACCC prefers to exclude tax from the WACC and include actual tax payments in their calculations of entity cash flows.

Thus Newmont finds itself in general support of the proposed WACC values to be used by the ERA in relation to Western Power’s network assets. We would certainly not wish to see higher values used, and consider that there are some assumptions which could be questioned, which could lead to a lower WACC than that proposed being adopted.

We would also support the concept of greater consistency in the treatment of WACC by the Australian Regulators and the publication of WACC values on a consistent basis so that an easy comparison can be made without companies having to recalculate results to express them on a consistent basis.

We would be happy to discuss our views with the ERA if considered desirable.

Yours sincerely

David Lyne
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Newmont Australia