

27 February 2004

Dr Ken Michael
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Dear Dr Michael

Review of Rate of Return Methodologies and Practices

The Chamber of Commerce and Industry of WA (CCI) has provided the following comments on the draft report entitled “Review of Rate of Return Methodologies and Practices” (the Review).

As a preliminary point, CCI notes that this report does not contain a great deal of quantitative and qualitative analysis. This type of analysis is important because it improves the credibility of the findings. In relation to the matters at hand it is important because:

- It has been recognised by the Productivity Commission (PC) that the assessment of regulatory rate of return is evolving. Therefore, in such an environment it would be appropriate for any assessment of regulatory best practice to involve a credible empirical justification process.
- The regulatory rate of return set by a regulator has the potential to impact on the financial performance of regulated industries and the customers of the regulated industry. The consequences of “getting it wrong” therefore could have a significant impact.
- Under the Western Australian legislative framework, if these reports are prepared for relevant purposes, industry will be required to pay for them under the funding arrangements. Any report that is not capable of appropriate levels of scrutiny should be avoided if industry is to be required to bear the costs.

While CCI notes that the paper attempts to outline the deterministic factors that are used to compute the theoretical regulatory cost of capital, we believe that a potential deficiency of this paper is that it does not consider the outcomes/recommendations that have arisen out of the PC’s Review of the National Access Regime and its current Review of the National Gas Access Regime.

In particular, the Review’s discussion in Chapter One on asymmetric risks is at odds with the PC’s determinations on this matter. We would urge the Economic Regulation Authority (ERA) to consider this matter and its impact on the outcomes of the Review.

The PC found in its review of the National Access Regime that there is a potential asymmetry in effects between over and under compensation. Briefly, it found that overcompensation will result in inefficiencies in the timing of new investment in

infrastructure, have adverse flow on effects to users and occasionally lead to inefficient by-pass of the networks. Conversely, however, it found that under compensation is likely to be more serious because it will potentially lead to lost investment in infrastructure with adverse flow on impacts.

In contrast, however, the discussion on Page 4 of the Review states that the ramifications of excess rates of return are equally adverse to those that flow when rates of return are too low.

Furthermore, there are a number of other aspects of the Review that require further scrutiny. These include:

1. The statement on page 9 that the regulator is to ensure that investors “earn only those returns which a competitive market would provide to the most skilful owners of a particular asset in the face of numerous competitors”. While CCI agrees that 'economic efficiency' should be the rationale, the recent Epic case decision interpreting the gas code suggests a lesser form of competition than that implied by this statement. The Supreme Court of WA found that a competitive market embodied the concept of workable, effective competition.
2. Moreover, section 8.30 of the Code requires the Regulator to “provide a return which is commensurate with prevailing conditions in the market for funds and the risk involved in delivering Reference Services...”. On that basis, we would recommend that the ERA consider whether, the report’s methodology for assessing the cost of capital reflects the methodology actually undertaken by investors investing funds in owners of regulated assets or the assets themselves.
3. The weight given to the Davis 1998 report’s findings that suggest that there is a downward trend in risk premiums. CCI notes that in the intervening 6 years there have been a number of significant international events that may have increased risk premiums.
4. The Review finds that neither the pre tax real or post tax nominal approaches have been clearly shown to be superior. It is not clear if this assessment took into account the advantage that the pre-tax approach is less intrusive.
5. As the Review indicates that it considers "evolving best practice", including in respect to the application of methodologies, a consideration of the benefits of using tools which minimise regulatory intervention. This would be consistent with the PC’s recommendations endorsing the use of light handed regulatory tools.
6. The Review’s findings on the gamma values determined by regulators could do with further explanation given that there is considerable uncertainty as to the effect the inability of foreigners to take advantage of imputation credits has. CCI is aware that there have been suggestions that the foreign investor is the marginal investor setting the price of Australian stocks, and as they are not able to claim imputation credits, that a gamma value closer to zero may be more appropriate.
7. In relation to the Review’s treatment of systematic and non-systematic risk, the PC in its draft report of the National Gas Access Regime notes that there is likely to be asymmetry in the manner regulators treat excess profits viz a viz lower than expected

profits in the next review period - regulators are more likely to capture excess profits than restore lower than acceptable profits to the appropriate level. This regulatory feature would suggest that regulatory risks may not be as diversifiable as the Review suggests in its discussion on these matters in section 3.1.

8. In order to ensure that there is fully informed debate on this issue, CCI recommends that the ERA should consider releasing any other reports that have been undertaken by it and its predecessors on rate of return issues.

The above matters are the issues that members have brought to CCI's attention. We trust that the ERA will consider the Review's treatment of these matters.

Yours sincerely

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