Financial Investor Group

Submission to the ERA's Draft Decision on Western Power's Proposed Revisions to the Access Arrangement for the South West Interconnected Network

The investor perspective

September 2009

Contents

***Inherent Limitations**: This report has been prepared as outlined in Section 2 of this report. The report indicates the sources of the information used. Members of the FIG have not sought to independently verify those sources unless otherwise noted within the report.*

***Third Party Reliance**: Other than our responsibility to the Economic Regulation Authority, no FIG member undertakes responsibility arising in any way from reliance placed by a third party on this report. Any reliance placed is that party's sole responsibility.*

1 Executive summary

This report by the Financial Investor Group ("FIG") is submitted in response to the ERA's Draft Decision, particularly as it relates to the cost of capital.

The FIG is an affiliation of eight major investors in Australian energy transmission and distribution networks. FIG members compete for ownership of infrastructure assets (including regulated energy networks), as well as for investors' funds that are, or may be, seeking exposure to this asset class. The five FIG members that this submission is made specifically on behalf of, own well over $3 billion of gas transmission and distribution assets in Western Australia.

The FIG has significant concerns with the ERA's Draft Decision given that it proposes returns that are simply inadequate to support private sector investment in regulated infrastructure in Western Australia. More specifically, the FIG has significant concerns with the:

- conclusions the ERA has drawn on the cost of capital and key parameters (e.g. the market risk premium, equity beta and gamma). These conclusions reflect not only a substantial shift in the ERA's views, but they also imply a cost of capital significantly below that allowed for owners of electricity network assets elsewhere in Australia; and

- process by which the ERA has arrived at a number of its conclusions, as this process would appear to contain numerous fundamental anomalies.

The cost of capital that the ERA has proposed is below the level necessary:

- to support the investment needed in Western Australian regulated energy networks; and

- to provide sufficient incentives for investors in the competitive market for capital to undertake infrastructure investment, particularly given:

    - prevailing market conditions for capital and the difficulty in raising capital, in light of the Global Financial Crisis and the emerging but fragile economic recovery;

    - the size of infrastructure investment needed both in other sectors in Western Australia, Australia more generally and internationally; and

    - the returns that are available from investing in infrastructure in other Australian and global jurisdictions.

The FIG believes that the ERA needs to fundamentally revisit its Draft Decision in respect of the cost of capital.

While this submission makes a number of references to the AER's Final Decision on WACC parameters, this is done primarily to highlight the inconsistencies in the ERA's decision and decision-making process. For the avoidance of doubt, the FIG wishes to place it on the record that it remains of the view that the AER's Final Decision provides an inadequate regulated rate of return, as it is below that currently required by equity investors in regulated infrastructure assets.

2 Introduction

2.1 The ERA's Draft Decision on Western Power's proposed Access Arrangement

Western Power owns and operates an electricity network, the South West Interconnected Network ("SWIN"), which serves the south-west of Western Australia.

The SWIN is covered under the Electricity Networks Access Code ("the Access Code"). Under the Access Code, Western Power is required to submit a proposed access arrangement that establishes, amongst other things, revenues and prices for third party access to the network. On 1 October 2008, Western Power submitted its Proposed Revisions to the Access Arrangement, and on 16 July 2009, the Economic Regulation Authority ("ERA") made its Draft Decision.

The ERA has requested submissions on the Draft Decision by 10 September 2009.

This report by the Financial Investor Group ("FIG") responds to the ERA's Draft Decision, particularly as it relates to the cost of capital.[1]

2.2 Who is the Financial Investor Group?

The FIG is an affiliation of eight major investors[2] in Australian energy transmission and distribution networks (refer Appendix A for more information on the members). FIG members compete for ownership of infrastructure assets (including regulated energy networks), as well as for investors' funds that are, or may be, seeking exposure to this asset class.

The eight FIG members have interests in well over $30 billion of Australian energy transmission and distribution assets, most of which are regulated. This accounts for a substantial proportion of the privately owned assets of this type in Australia, and over 40% of the total value of Australian regulated energy transmission and distribution assets.[3]

This submission is supported by all eight members of the FIG and is made specifically on behalf of five members of the Group: the APA Group; Babcock and Brown Infrastructure; the DUET Group; Hastings Funds Management and Singapore Power International. These five FIG members own well over $3 billion of gas transmission and distribution assets in Western Australia, including ownership interests in the following assets:

- the Dampier to Bunbury Natural Gas Pipeline;

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[1] The FIG has been assisted by KPMG in preparing this submission. The views expressed remain those of the FIG and are not necessarily those of KPMG. KPMG has prepared an independent report for Western Power and some of the material in this submission draws from that report.

[2] The FIG members are the APA Group, Babcock and Brown Infrastructure, Cheung Kong Infrastructure, the DUET Group, Hastings Funds Management, Hongkong Electric, Singapore Power International and Spark Infrastructure.

[3] This is based on AER data. See, AER, *State of the Energy Market Report*, 2008. It relies on RAB values for regulated and actual cost for non-regulated assets, but excludes recent capex for certain assets due to information constraints. By value the vast majority of these assets are subject to formal economic regulation. The other major owner is Envestra, but APA and CKI have a 30.6% and 18.5% ownership interest in Envestra respectively.

- the Goldfields Gas Pipeline;
- the Mid-West and South-West Gas Distribution Systems; and
- various other pipelines mostly in the mid-west and north-west regions of Western Australia. These other assets include: the Midwest Pipeline, the Telfer Pipeline, the Pilbara Energy Pipeline, the Burrup Energy Pipeline and the Kalgoorlie-Kambalda Pipeline.

The FIG therefore has a significant interest in how energy infrastructure in Australia and Western Australia is regulated, both directly and on behalf of their investors. The regulated cost of capital is a critical component of investment decisions, given that it typically accounts for at least 30% of regulated revenues in electricity networks and typically accounts for well over 50% of revenue on pipelines. Moreover, given regulation typically seeks to ensure that any changes to regulatory depreciation are revenue neutral in net present value terms, in practice the regulated cost of capital generally accounts for over 60% of revenues in electricity networks and more again in pipelines.

2.3 Why is the Financial Investor Group making a submission?

The FIG was originally drawn together by concerns about the Australian Energy Regulator's ("AER's") first periodic review of certain WACC parameters as prescribed by the National Electricity Rules.[4] That review applies only to electricity determinations[5] in the eastern States.

Specifically, the FIG's concerns related to the nature and direction of the WACC review, which in estimating parameter values focussed almost exclusively on technical matters and gave little regard to market conditions, particularly in light of the Global Financial Crisis. The FIG believed that the AER had lost sight of the commercial importance of the cost of capital and the role that it plays in the investment decisions made by private sector infrastructure investors operating in a competitive and particularly challenging capital market, where private investors have many alternative investment opportunities available.

The FIG believes that setting a regulated cost of capital must ultimately be guided by commercial and practical considerations, as this is the perspective that investors will take when making investment decisions, as it believes has been recognised in the National Gas Law and the National Electricity Law.[6] Failure to do so will result in much-needed capital for energy network investment being shifted to other investment opportunities.

The AER's Final Decision represented a minor improvement on the draft, but the outcome remains a concern to FIG members.

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[4] FIG, Submission to the AER's WACC parameter review: The investor perspective: January 2009 http://www.aer.gov.au/content/item.phtml?itemId=726833&nodeId=1f5b147a6952ac4b1152f668ef9e4495&fn=Financial%20Investor%20Group%20submission%20on%20explanatory%20statement%20(29%20January%202009).pdf

[5] The AER states that the decision "has no direct or formal applicability to gas access arrangements". See AER, Electricity transmission and distribution network service providers Review of the weighted average cost of capital (WACC) parameters: Final decision, May 2009, page 6.

[6] The National Gas Objective is very similar to the National Electricity Objective. The requirements on the rate of return are also similar: to be commensurate with prevailing conditions in the market for funds and the risk involved in providing the services.

While this submission makes a number of references to the AER's Final Decision, this is done primarily to highlight the inconsistencies in the ERA's decision and decision-making process. For the avoidance of doubt, the FIG wishes to place it clearly on the record that it remains of the view that the AER's Final Decision provides an inadequate regulated rate of return, as it is below that currently required by equity investors in regulated infrastructure assets.

The FIG has similar concerns relating to the ERA's Draft Decision given that it proposes returns that are simply inadequate to support private sector investment in regulated infrastructure in Western Australia. In addition, the FIG is concerned about the Draft Decision as it not only creates significant uncertainty which will increase regulatory risk given the fundamental inconsistencies with the AER's Final Decision, but also adopts a process which would appear to contain fundamental anomalies.

FIG members believe that, if anything, higher returns are required for certain infrastructure assets in WA (as the ERA has previously recognised), for reasons outlined in this submission.

3 Key features of the ERA's Draft Decision

The ERA's Draft Decision has a number of notable features, some of which are of particular concern to the FIG.

The FIG's major concern is the ERA's proposals in regard to the cost of capital, and the inadequate regulated rate of return it provides. A number of the values proposed by the ERA for certain WACC parameters are also significantly different, and lead to a materially lower cost of capital, to those recently decided by the AER. For example, the ERA proposes the following parameter ranges:

- equity beta of 0.50 to 0.80, implying a midpoint of 0.65, while the AER's value is 0.80;
- market risk premium (MRP) of 5.0% to 7.0%, implying a midpoint of 6%, while the AER's value is 6.5%; and
- gamma of 57% to 81%, implying a midpoint of 69%, whereas the AER's value is 65%, a value which in itself is not supported by available evidence and is the subject of an appeal by the NSW distributors. The range proposed by the ERA implies a precision in measuring gamma which is not evident in other academic or regulatory discussions and surveys on the possible value of gamma.

This submission focuses largely on our concerns with the ERA's choice of parameter values, the implications it has for the cost of equity and the incentives for, and the risks associated with, investment.

In addition, the FIG understands that the large price increases that have been proposed by Western Power are driven by the significant levels of capital expenditure incurred over the current access arrangement period, as well as the large capital expenditure program which has been proposed for the next access arrangement period. Whilst the ERA may be concerned about the size of the proposed price increases, the FIG questions whether the measures that the ERA has taken to reduce the proposed price increases are appropriate. In particular, the FIG is concerned about the proposal to reduce Western Power's proposed opening capital base value for the second access arrangement period by $474 million, and the proposal to defer approximately $407 million of revenue to avoid price shocks.[7] Both of these issues are also addressed further in this submission, because they are relevant to investment risk.

3.1 Key issues with the ERA's Draft Decision

The FIG has significant concerns with the conclusions the ERA has drawn on the cost of capital.

The FIG also has issues with the process by which the ERA has arrived at a number of its conclusions. This is because the ERA's approach would appear to involve:

- inconsistencies compared to how it has applied the Access Code in the past;

[7] The deferred revenues relate or have been tied to changes in the approach to capital contributions.

- inconsistencies with past decisions on how it has made certain rulings on WACC parameters and the factors it has taken into account in doing so (e.g. when, and the extent to which, it has followed the precedent of the AER in relation to gamma and equity beta);

- failing to take into account significant issues in making decisions on WACC parameters (e.g. the Global Financial Crisis and its effect on the market risk premium);

- inconsistencies in the conclusions it has drawn on some WACC parameters and on the way in which they have been drawn (e.g. MRP and gamma), particularly relative to its approach in other very recent regulatory decisions; and

- making decisions on certain issues without adequately addressing the effects of those decisions (e.g. in retrospectively disallowing capital expenditure and deferring revenue).

The FIG also considers that the ERA's assessment of WACC parameter values could have been improved by examining counter arguments put forward in the AER's review process.

We note that some aspects of the AER's approach to the cost of capital (e.g. setting the risk free rate and credit margin estimation) are now the subject of an appeal by the NSW electricity distributors in the context of their recent price determination. We understand the AER's decision on WACC parameters provided limited opportunity for merits review, but may provide this opportunity in the context of particular revenue determinations.

These issues seriously draw into question the basis on which the ERA has made its Draft Decision and the decision itself.

The remainder of this report examines the implications for investment of the ERA's Draft Decision, and explains the FIG's concerns with the Draft Decision in more detail.

4 Implications of the Draft Decision for investment

The FIG's concerns with the Draft Decision are important because aspects of the decision itself, and the basis on which these have been made, send signals to investors about the:

- relative attractiveness of investing in regulated assets in Western Australia; and
- regulatory precedent, consistency and risks associated with the investment environment in Western Australia.

4.1 Investing in regulated infrastructure in Western Australia

The key implications of the ERA's Draft Decision would appear to be:

- that Western Power should be prepared to invest for a significantly lower regulated rate of return than that provided to owners of electricity network assets elsewhere in Australia, even though the rates of return provided to owners of electricity network assets elsewhere in Australia are, in our view, insufficient to encourage sufficient private sector investment; and
- that, if the ERA adopts a similar approach to the gas networks and pipelines it regulates,[8] owners of those assets in Western Australia would also almost certainly earn a significantly lower regulated rate of return than elsewhere in Australia.

It is clear that using the ERA's values for the equity beta and MRP means that the cost of equity provided to Western Power is 1.30 percentage points (or 15%) lower in real terms than that provided by the AER on similar types of assets elsewhere in Australia. This result is particularly disappointing given that the AER's decision on WACC is of itself insufficient, and in our view, at odds with available evidence which suggests that the rates of return on equity that are being targeted by infrastructure funds globally is (at a minimum) in the range of 10% to 20%.[9] Within Australia, the current trading yields of listed infrastructure funds suggest that the current cost of raising new equity is towards the upper end of this range, that is, 15% to 20%.

There is also evidence that higher returns are also available in the US electricity transmission and distribution sector. For example, in March 2009, the US Federal Regulator, FERC, approved a 12.54% return on equity for a 240 mile high voltage power line in Indiana and in April it approved rate incentives for the Green Power Express transmission project. This is a 3,000 mile transmission project to bring wind power from North and South Dakota to Chicago. This decision allows a 12.38% return on equity.

By contrast, the return on equity reflected in the AER's WACC decision (which we estimate is currently around 10.88%) for electricity networks lies very low down on the scale of returns available to global investors in infrastructure. Within this context, the ERA's proposed return on equity (which is below 10%) is totally inadequate.

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[8] The Draft Decision references gas-market specific information, notwithstanding that its decision only relates to electricity under the Access Code.

[9] Preqin, Infrastructure Spotlight, March 2009/Volume 2 – Issue 3, Feature Article: Infrastructure Fund Performance: Low Risk, Low Returns?

The FIG considers that there are strong reasons to suggest that the ERA cannot expect to attract any investment into WA energy infrastructure assets with the level of return that it is proposing to offer investors.

First, regulated energy infrastructure projects in Western Australia compete for funds with other regulated and non-regulated infrastructure projects in Western Australia, as well as with infrastructure projects in the rest of Australia and internationally. In addition, these projects are competing in a market environment in which capital remains difficult and costly to raise.

Second, it is widely accepted that the infrastructure investment need in Australia and globally is substantial, notwithstanding the slow down that may have been triggered by the Global Financial Crisis. In Western Australia alone:

- real business investment in 2009/10 will be the second highest on record (after 2008/09) and is expected to remain at levels that are roughly double that seen prior to 2004/05;

- the State Government's asset investment program in 2009/10 will be the largest ever and is also expected to remain, on average, at levels that are roughly double that seen prior to 2004/05. This program involves investments of $23.8 billion over four years in electricity, water, roads and social infrastructure;[10] and

- gas network infrastructure that might proceed includes:

    - the Bunbury to Albany pipeline;

    - the Derby to Dampier pipeline;

    - infrastructure associated with the Wheatstone and Gorgon gas field developments (the latter will be, at $50 billion, Australia's largest ever resources project);

    - transmission and/or gathering lines to provide capacity in existing pipelines that enable gas to be delivered to new gas fired generators at "peak" times; and

    - pipelines (mainly laterals) to proposed developments in the Mid-West.

Depending on the final outcomes of the Federal Government's Carbon Pollution Reduction Scheme, further gas infrastructure investments may be needed as gas fired generation replaces coal fired generation.

It is difficult to overstate the significance of the potential ongoing development need in Western Australia. In relation to LNG developments, on 19 August 2009, the Premier of Western Australia stated that the State is set to become the "Saudi Arabia of natural gas".[11]

[10] Hon. Troy Buswell, Treasurer, Asset Investment Program Forum, 3 June 2009.
[11] http://news.theage.com.au/breaking-news-national/wa-saudi-arabia-of-lng-premier-20090819-eq1y.html

The level of infrastructure investment required in the rest of Australia and internationally is also substantial. The FIG's submission to the AER's review demonstrated this at some length. In summary, it stated:

> *"Appendix A shows that there is massive global demand for infrastructure investment and energy infrastructure investment. In particular, projections suggest that in the period to 2030, $109 trillion of investment is required in the road, rail, telecoms, electricity generation and water sector. The energy infrastructure sector will require $40 trillion over the same period, of which 25% will be spent on energy networks. At the same time, there is huge demand for Australian infrastructure investment across a range of sectors, including energy and energy networks. Over the next 10 years the investment required in Australian infrastructure (both economic and social) is around $445-700 billion. The energy network expenditure component of this is around $40 billion."*[12]

While some of that investment will be deferred or avoided in the light of the Global Financial Crisis, the investment need will remain very considerable.

With the wide range of competing projects seeking to attract investment, and given the investment losses that have been sustained as a result of the Global Financial Crisis, capital is unlikely to flow to projects which do not offer a sufficiently attractive return for the risk that investors bear, particularly in the context of the global market for infrastructure investment opportunities. Within this context, the ERA needs to demonstrate how its Draft Decision is consistent with meeting the investment need for WA energy infrastructure assets. In particular, why it is appropriate to have a lower:

- MRP for electricity networks in Western Australia compared to other electricity transmission and distribution assets in Australia; and

- equity beta for the SWIN compared to other electricity transmission and distribution assets in Australia. Economic regulators in Western Australia have previously formed the view that higher rates of return on certain energy transmission and distribution (and rail assets) are warranted.[13]

The FIG believes that the question for the ERA is simple:

> *Why would an equity investor choose to direct scarce capital to an asset in Western Australia, when it could direct that capital to an asset it owns elsewhere in Australia or globally and be assured of getting a significantly higher regulated return?*

The ERA needs to be aware that these are precisely the capital allocations decisions that FIG members and their underlying equity investors are required to make on an ongoing basis. Unless there are strong and valid reasons for why a lower regulated return is warranted in Western Australia, decisions such as the ERA's Draft Decision on the SWIN puts future investment in Western Australia infrastructure at risk.

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[12] FIG, Submission to the AER's WACC parameter review: The investor perspective, January 2009, page 18.

[13] The ERA's June 2009 decision on TPI's rail assets, the ERA's May 2005 decision on the Goldfields Gas Pipeline and OffGAR's May 2003 decision on the Dampier to Bunbury Natural Gas Pipeline.

4.2 Regulatory risks to the investment environment

As outlined in Section 3.1, the FIG is also concerned with how aspects of the Draft Decision have been made. The specific matters that we are concerned with are detailed in Section 5.

Investors are concerned about regulatory processes primarily because they provide an indication of how a given regulator is choosing to interpret its duties and utilise its discretion. As such, regulatory processes provide a lead indicator of the possible variations in regulatory outcomes that might occur in future decisions. In other words, for investors, regulatory processes go directly to assessing the transparency, certainty and predictability of a regulatory regime.

The cost of regulatory uncertainty was highlighted in the market's reaction to the AER's Draft Decision, as was outlined in some detail in the FIG's submission to the AER.[14] Macquarie Equities captured the mood at the time when it stated that:

> *"Is this the AER or its Victorian state-based predecessor, the Essential Services Commission (ESC), who was in the nasty habit of handing out a tough draft followed by a light final decision?*
>
> *This is a negative surprise to us and the market and in our view runs inconsistent with recent commentary by the AER"* [15]

The AER subsequently acknowledged that some of its proposed changes to the WACC parameters were unexpected by market analysts.[16]

Regulatory processes that are perceived to be inconsistent, opaque or arbitrary create substantial risks for investors, particularly in long-lived assets. They require investors to make highly subjective judgements about possible regulatory outcomes. In these circumstances, investors will either:

- choose not to invest because the regulatory regime is perceived to be too risky; or
- only invest where the expected returns compensate for the additional risks involved (which, for regulatory risk, will be valued conservatively since such risks are hard to quantify and thus value).

Providing a competitive rate of return on investment in regulated infrastructure is therefore a necessary condition (but not, of itself, a sufficient condition) to encourage investment that is consistent with promoting economically efficient investment in electricity networks and thus customer needs. The regulatory regime also needs to be transparent, stable and predictable. Unfortunately, the ERA's Draft Decision raises a number of issues that create substantial uncertainty in this regard.

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[14] FIG, Submission to the AER's WACC parameter review: The investor perspective: January 2009, pages 15-17.
[15] Macquarie Research Equities, *Regulated Utilities – WACCed*, 12 December 2008.
[16] AER, Electricity transmission and distribution network service providers Review of the weighted average cost of capital (WACC) parameters: Final decision, May 2009, page 36.

5 The FIG's concerns with the ERA's Draft Decision

5.1 Key concerns with the ERA's decision on WACC

The FIG's key concerns with the ERA's Draft Decision on WACC relate to:

- how it has formed its view on the appropriate WACC to apply;
- its consistency with, or justification for departing from, the recent decision made by the AER; and
- its conclusions on a number of key parameter values, particularly in light of market conditions associated with the fallout from the Global Financial Crisis, and the process by which it has formed these conclusions.

5.1.1 The ERA's approach to the Draft Decision on WACC

The basis on which the ERA has made its Draft Decision is inconsistent with how the ERA has interpreted the Access Code in the past.

In the ERA's last final decision on the SWIN, it:

- arrived at a reasonable range for the WACC;
- evaluated Western Power's proposed WACC against this range; and
- concluded that it was acceptable because it fell within the range.[17]

Moreover, the ERA did not previously express any views on the merits of a particular point estimate within its reasonable range of values. In the 2006 draft decision on the SWIN, the ERA only refers to a point estimate that "meets" the requirements of the Access Code.[18]

In the current Draft Decision, however, the ERA has rejected Western Power's proposed WACC on the basis that it falls outside of its preferred range of values (i.e. 6.38% to 7.74%). It then proposes a cost of capital that reflects the "central value" of its range (i.e. 7.06%) as a value that "better" meets the objectives of the Access Code:

> *"there are no particular circumstances of the SWIN that would cause a value of the WACC in either the lower or upper part of the range of values indicated in paragraph 774 to* ***better*** *meet the relevant objectives of the Access Code".*[19] (emphasis added)

[17] ERA, Final Decision on the Proposed Access Arrangement for the South West Interconnected Network, 2 March 2007, paragraph 453.
[18] ERA, Draft Decision on the Western Power Networks Business Unit Proposed Access Arrangement for the South West Interconnected Network, 21 March 2006, paragraph 681.
[19] ERA, Draft Decision on Proposed Revisions to the Access Arrangement for the South West Interconnected Network, 16 July 2009, paragraph 777.

The FIG's view is that in order to provide adequate incentives for investment in an environment where capital is constrained relative to the size of investment needs of WA, it is necessary to select values towards the higher end of a reasonable range underpinned by soundly based parameter values, which fully reflect current market conditions.

Putting that issue aside, the FIG observes that the ERA's approach would appear to be inconsistent with the proper interpretation of the Access Code, which is that the ERA is obliged to accept a proposal unless it is demonstrably inconsistent with the Access Code. As Section 4.28 (b) of the Access Code states:

> *"to avoid doubt, if the Authority considers that the Code objective and the Requirements, ..., are satisfied, it* ***must not*** *refuse to approve the proposed access arrangement on the ground that another form of access arrangement might better or more effectively satisfy the Code objective and the requirements…"*[20] (emphasis added)

The Access Code also contains a note which states:

> *"The effect of section 4.28 is to make the Authority's decision in relation to a proposed access arrangement a pass or fail assessment."*

The ERA's approach in its Draft Decision is also inconsistent with the approach it has used in at least two recent decisions it has made under the National Third Party Access Code for Natural Gas Pipeline Systems ("the Gas Code"). The decisions relate to the access arrangements for the Mid-West and South-West Gas Distribution Systems[21] and the Dampier to Bunbury Natural Gas Pipeline.[22] In both cases, the ERA ultimately accepted proposals by the businesses that were within its reasonable range.

Possible implications of the ERA altering its interpretation of the Access Code

There are two possible interpretations of the ERA's Draft Decision: the apparent change in how the ERA is interpreting the Access Code is either deliberate, or it is an oversight. The fact that there are two plausible interpretations of the ERA's Draft Decision is of itself a cause for significant concern to the FIG, but that is the situation as it stands.

If the first interpretation is more accurate, then this represents a fundamental shift in the ERA's position. It also implies that the ERA holds a significantly different view to the AER on appropriate key WACC parameter values for regulated assets.

There is some evidence to suggest that the change in the ERA's approach is deliberate. This includes:

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[20] Electricity Networks Access Code, unofficial consolidated version, 4 November 2008, page 51.

[21] ERA, Draft Decision on the Proposed Revisions to the Access Arrangement for the South-West and Mid-West Gas Distribution Systems, 28 February 2005. ERA, Final Decision on the Proposed Revisions to the Access Arrangement for the South-West and Mid-West Gas Distribution Systems, 12 July 2005, page 72. paragraph 368.

[22] ERA, Draft Decision on the Proposed Revisions to the Access Arrangement for the Dampier to Bunbury Natural Gas Pipeline, 11 May 2005, page 51. ERA, Final Decision on the Proposed Revisions to the Access Arrangement for the Dampier to Bunbury Natural Gas Pipeline, 2 November 2005, page 54.

- the specific wording used by the ERA to justify why there is no "better" estimate than the central value (and, moreover, using the term that the Access Code uses to define what the ERA **should not do**);

- the apparent preference the ERA has for using best (point) estimates (e.g. the ERA's rail sector access determinations);[23] and

- the ERA's most recent rail Final Determination, which suggests that it believes some of its parameter estimates underlying its "central value" proposed for Western Power are in fact best estimates.

If the second interpretation - that is the change in the ERA's approach is an oversight - is more accurate, then this implies that the ERA may accept amended revisions that are consistent with the range it has determined (i.e. an estimate at the top end of the feasible range), if Western Power makes such a proposal. We note that using the AER's values for MRP, equity beta and gamma would produce a real pre-tax WACC of 7.59%, below the top end of the ERA's range, which is 7.74% in the Draft Decision.

This approach would remove, at least implicitly, the key anomalies between the ERA's Draft Decision and the AER's views. It would, however, still mean that risks exist for investors in other regulated network assets in Western Australia (and assets that could become subject to regulation). For example, it would:

- show that while the ERA is currently prepared to accept a WACC estimate that implies use of the parameter values used by the AER, it is not prepared to accept that they are best estimates (and its decisions on other assets suggest it does not believe this is the case); and

- create uncertainty with the proposed move from using the Gas Code to the National Gas Law in Western Australia, which we understand is likely to occur quite soon.[24] This is because the National Gas Law may provide regulators with the discretion to select their preferred point estimate of the cost of capital, although this is yet to be tested. In these circumstances, the risk for investors is that ERA would revert to using its "best" point estimates, which implies a cost of capital similar to its Draft Decision.

In both scenarios, there is a considerable risk for investors in WA regulated infrastructure assets that the ERA's approach will lead to a significantly lower cost of capital, which is disconnected from market realities (and also from the AER's position) and therefore create substantial uncertainty for future investment in WA regulated infrastructure.

The FIG cannot see any reason for why this outcome is warranted. To remove this uncertainty and provide positive signals for future investment in WA, the FIG urges the ERA in its Final

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[23] ERA, Final Determination on the 2009 Weighted Average Cost of Capital for the Pilbara Infrastructure ("TPI's") Railway Network. See also the ERA's decisions on WestNet Rail and the Public Transport Authority. Railway assets are regulated under the Railways (Access) Act 1998 (WA) and the Railway Access Code (2000) (WA). The former has a similar objects provision as the Access Code. The regulatory regime for rail does not appear to limit the ERA's discretion to make decisions on access arrangements that would "best" meet the Railway Code and does not appear to provide any additional guidance on how to estimate a rate of return that is consistent with it.

[24] We understand the legislation is currently before the Western Australian Parliament.

Decision to adopt the parameter values used by the AER as its lower bound values. If it fails to do this, the ERA should inform investors how its decision should be interpreted.

5.1.2 Key differences with the AER's final decision

The FIG has a number of issues with the process of estimating values, and the values ascribed to the market risk premium, equity beta and gamma. These issues are highlighted, in part, by the differences in the conclusions drawn by the ERA and the AER, as well as by the extent to which the ERA's decision reflects market conditions, particularly in light of the Global Financial Crisis.

Context for the AER's decision on WACC parameter values

The AER's decision was made under the National Electricity Law ("NEL") and the National Electricity Rules ("NER") in May 2009.[25]

The NER specifies the values to be used for certain parameters critical to determining the rate of return for electricity transmission businesses, and a periodic process for reviewing those values. The NER also states that, where the values that are attributable to the above parameters cannot be determined with certainty, the AER must, amongst other things, have regard to:

(i) *the need to achieve an outcome that is consistent with the national electricity objective; and*

(ii) *the need for persuasive evidence before adopting a value for that parameter that differs from the value that has previously been adopted for it.*[26]

It is worth noting that these developments were one of the key outcomes of a long period of dispute and policy work on the merits of the economic regulation of Australian energy infrastructure. This policy focus followed various decisions by Courts[27,28,29,30] on the interpretation of aspects of access regulation, as well as views expressed by authoritative and independent sources.[31,32,33] These regulatory developments (which primarily took place in the period up until 2004) highlighted the importance of avoiding regulatory error and the risks to

[25] The ERA's decision is under the Access Code, but the differences between the objectives of the two instruments would appear to be modest. The objective of the Access Code is to promote the economically efficient: (a) investment in; and (b) operation of and use of, networks and services of networks in Western Australia in order to promote competition in markets upstream and downstream of the networks. In relation to the rate of return, the Access Code requires giving the service provider an opportunity to earn an amount of revenue that meets the forward-looking and efficient costs of providing covered services, including a return on investment commensurate with the commercial risks involved. The objective of the National Electricity Law is to promote efficient investment in, and efficient operation and use of, electricity services for the long term interests of consumers of electricity with respect to price, quality, safety, reliability, and security of supply of electricity; and the reliability, safety and security of the national electricity system.

[26] National Electricity Rules Version 20, Chapter 6A Economic Regulation of Transmission Services, 6A.6.2(j)(4) and Chapter 6, 6.5.4(4).

[27] Application by Epic Energy South Australia Pty Ltd [2003] ACompT 5.

[28] Application by GasNet Australia (Operations) Pty Ltd [2003] ACompT 6.

[29] Application by East Australian Pipeline Limited [2004] ACompT 8.

[30] *Re Dr Ken Michael AM; Ex parte Epic Energy (WA) Nominees Pty Ltd* [2002] WASCA 231.

[31] Government Response to the Productivity Commission Review of the National Access Regime, 17 Sept. 2002.

[32] Productivity Commission, Review of the Gas Access Regime, Canberra, June 2004.

[33] Council of Australia Governments Energy Market Review Panel, Towards a Truly National and Efficient Energy Market: Final Report [Parer Report], 20 December 2002.

infrastructure investment, and thus the long term interests of customers, that might arise from those errors. This process ultimately led to the development of national regulation, and the NEL and NER.

In discussing the rationale for setting the values of the parameters that are critical to determining the rate of return, the AEMC stated:

> *"The provision of stability in the short term regarding the determination of the WACC reduces an important source of potential variability in regulatory decision making providing a more certain and predictable environment for investment and financing decision-making."*[34]

The NEL therefore explicitly sought to place a high standard or burden of proof on a regulator when it is required to contemplate making changes to these parameter values.

It is surprising in these circumstances that the ERA has not attached significant weight to the findings of the AER. This is particularly the case given that Mr Steve Edwell, the chairman of the AER, is also one of three members of the ERA. It is difficult to imagine circumstances that could create more regulatory uncertainty.

It is unclear whether the apparent inconsistencies between the ERA's views on the appropriate WACC parameter values and those of the AER are attributable to the ERA's belief that the specific circumstances in Western Australia warrant different WACC parameter values to be adopted, or whether it has settled on different values because it genuinely disagrees with the AER's decisions. In any event, the ERA has not sought to justify its departure from the AER's conclusions based on specific Western Australia circumstances or technical grounds.

5.1.3 The market risk premium

The FIG notes that the ERA has not taken into consideration the impact of the Global Financial Crisis in its assessment of the appropriate value for the MRP. This is reflected in the fact that:

- it makes no mention whatsoever of prevailing market conditions and the impact of the Global Financial Crisis in assessing the MRP; and
- the midpoint of the ERA's Draft Decision – 6% – reflects the value that has historically been adopted in regulatory decisions in Australia that were made during stable economic conditions.

It is difficult to understand why the ERA does not consider the Global Financial Crisis to be a relevant consideration in its assessment of the MRP. Whilst the FIG is aware that there are emerging signs of a recovery in economic conditions, we consider that it would be premature to suggest with any confidence that a turnaround has occurred and that the worst is definitely over. As the Organisation for Economic Co-operation and Development has noted in its recent Interim Economic Assessment, despite positive signs of a turnaround on many indicators:

> *"numerous headwinds imply that the pace of the recovery is likely to be modest for some time to come. Ample spare capacity, low levels of profitability, high and rising unemployment, anaemic*

[34] AEMC, Draft Rule Determination, 2006, pages 57-61.

growth in labour income and ongoing housing market corrections will moderate any uptick in private demand. At the same time, the need remains for households, businesses, financial institutions and governments to repair the damage to their balance sheets."[35]

It is therefore still relevant and necessary for the ERA to consider how current economic conditions may affect its assessment of the MRP.

We observe that in the ERA's June 2009 determination on TPI's rail assets,[36] the ERA received some submissions which suggested an increase in the MRP was warranted, and noted the AER's decision to increase the MRP to 6.5%. However, the ERA's final determination for that asset shows that the ERA declined to shift from a value of 6% for the MRP.

The ERA's final determination on TPI's rail assets clearly attributes this aspect of its decision to *"comments"* made by its WACC adviser (CRA) *"to the effect that"* the MRP had not changed.[37] However, the FIG notes that at the outset of the determination, the ERA stated that:

*"CRA was **not** asked to provide the Authority with detailed advice on the CAPM or the **market risk premium**."*[38] (emphasis added)

The analysis above would appear to raise questions about both the process by which the ERA has arrived at a value for the MRP for Western Power and the factors it has taken into account.

As the AER has correctly observed, current economic conditions are not stable:

"The AER considers that prior to the onset of the global financial crisis, an estimate of 6 per cent was the best estimate of a forward looking long term MRP, and accordingly, under relatively stable market conditions – assuming no structural break has occurred in the market – this would remain the AER's view as to the best estimate of the forward looking long term MRP. However, relatively stable market conditions do not currently exist and taking into account the uncertainty surrounding the global economic crisis, the AER considers two possible scenarios may explain current market conditions:

- *that the prevailing medium term MRP is above the long term MRP, but will return to the long term MTP over time; or*
- *that there has been a structural break in the MRP and the forward looking long term MRP (and consequently also the prevailing) MRP is above the long term MRP that previously prevailed.*

Whilst it cannot be known which of these scenarios explain current financial conditions, both are possible, and both suggest a MRP above 6 per cent at this time may be reasonable…"[39]

There is clear evidence that the Global Financial Crisis has resulted in heightened levels of risk aversion, and this could persist well into the future. On this basis, the FIG considers that there is a strong case for the ERA to lift the value of the MRP well above 6%. The FIG is of the view that the AER's decision on the MRP does not fully reflect the impact of current market conditions on the cost of equity, but is closer to the correct value than the ERA's position.

[35] OECD, What is the Economic Outlook for OECD countries? An Interim Assessment, 3 September 2009, page 2.
[36] ERA, Final Determination on the 2009 Weighted Average Cost of Capital for TPI's Railway Network, 22 June 2009
[37] Ibid., paragraph 116.
[38] Ibid., paragraph 27.
[39] AER, Final Decision, ibid., page 238.

5.1.4 Equity beta

It is well-documented that empirical measurement of the equity beta is an inherently difficult exercise and that the resulting estimates frequently suffer from high levels of estimation error. Recognising this, regulators have historically tended to place more weight on other factors and less weight on empirical evidence when assessing the appropriate value for the equity beta.

This practice has continued with the AER's recent WACC decision, where the AER noted that whilst market data suggests a value for the equity beta that is lower than 0.8, "*…the AER has given consideration to other factors, such as the need to achieve an outcome that is consistent with the NEO (in particular, the need for efficient investment in electricity services for the long term interests of consumers of electricity).*" [40]

By contrast, it is not apparent from the ERA's Draft Decision that the broader objectives in setting WACC have had any bearing on its decision on the equity beta value.

It is perhaps worth noting the views of NSW Treasury in its submission to the AER's review. It stated as follows:

> *"The AER's Explanatory Statement presents a vast quantity of highly technical and often conflicting academic advice and market evidence from a wide range of stakeholders. It is relatively easy to justify either higher or lower individual WACC parameters based on selective use of the wide ranging evidence available. Ultimately, the regulator needs to apply regulatory judgement in determining a reasonable final outcome that satisfies the National Electricity Objective of encouraging efficient investment for the long term interests of customers."*[41]

Nowhere are these views more appropriate than in the consideration of equity beta.

The net effect of the ERA's Draft Decision on the equity beta and the MRP is to reduce the real after tax cost of equity by 130 basis points relative to the AER. It produces a real after tax cost of equity of 6.95%. The ERA's decision to use an equity beta of 0.65, as opposed to the 0.80 applied by the AER accounts for 90 basis points of the total difference.

This is an inappropriate decision at a time when capital markets have experienced unprecedented levels of turmoil and the cost of equity has obviously increased materially. The FIG's submission to the AER's review outlined the evidence to support this in some detail.

The ERA's Draft Decision will therefore damage the regulated energy infrastructure investment environment in Western Australia if not rectified in its Final Decision.

Investors place a high degree of value on regulatory stability, predictability and certainty. The FIG submits that this consideration should be a key objective of the ERA's decision on the SWIN given the particularly high levels of investment that the asset requires going forward.

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[40] AER, Final Decision, Electricity transmission and distribution network service providers, Review of the weighted average cost of capital (WACC) parameters, May 2009, page 343-344.

[41] NSW Treasury, Weighted Average Cost of Capital: Response to the Australian Energy Regulator Review of Electricity Transmission and Distribution WACC Parameters, January 2009.

There is no case for the ERA to adopt an equity beta lower than that used by the AER. There may, however, be a case for adopting a higher equity beta, for the reasons outlined in Section 5.2 below.

5.1.5 Gamma

Issues with the ERA's process

The ERA's Draft Decision proposes a range for gamma between 0.57 to 0.81. The ERA concludes that this is consistent with a distribution rate of 1.0 and an utilisation rate of 0.57 to 0.81. It also notes that this is consistent with the findings of the AER, which proposed a range of 0.57 to 0.74,[42] and settled on a midpoint estimate of 0.65.

The ERA has relied on the conclusion drawn by the AER in relation to gamma. It states:

> *"In considering the value of imputation credits, the Authority has had regard to the detailed consideration given by the AER to this element of the WACC calculation."*[43]

The ERA provides no explanation as to why the AER's views are particularly worthy of consideration in relation to this parameter. We note that the result of the ERA taking into account the AER's views on this parameter is that it proposes a lower WACC than would otherwise be the case.

The ERA's position on gamma in the Draft Decision represents a significant shift on a position it only arrived at recently, after considering the AER's decision. The ERA has issued two decisions since the AER's final decision in May 2009, but has only chosen to be consistent with the AER's final decision in one of these cases:

- on 22 June 2009, the ERA made its Final Determination on the WACC for the TPI's rail infrastructure which used a gamma of 0.50; and
- on 16 July 2009, the ERA made its Draft Decision on the WACC for Western Power, proposing a value for gamma which it regards as being consistent with the AER's decision.

The process by which it arrived at its conclusions on gamma for TPI's rail assets is instructive. The ERA's Final Determination discusses its Draft Determination (made in January 2009). It states:

> *"Australian regulators are faced with varying and conflicting theory and evidence on the value of franking credits. Evidence on the value of the imputation factor (including the impact of changes in taxation law on this value) supports gamma values anywhere in the range of zero to one.*
>
> *The Authority is left with a need to make a determination on the current value of gamma to be applied in TPI's WACC Determination with the major conceptual issues unresolved."*[44]

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[42] The higher end of the AER's range reflected a midpoint of a range of estimates from a study by Handley and Maheswaran (2008), whereas the high end of the ERA's range reflects the high end of the estimates in Handley & Maheswaran (2008).

[43] ERA, Draft Decision on Proposed Revisions to the Access Arrangement for the South West Interconnected Network, 16 July 2009, paragraph 751.

In the section 'Authority's Final Determination', the ERA then states:

> *"The Authority also notes that the AER has recently adopted a gamma of 0.65 in its final Statement of the Revised WACC Parameters (Transmission) and Statement of Regulatory Intent on the Revised WACC Parameters (Distribution) in May 2009.*
>
> *However, the Authority does not consider that the uncertainty relating to an appropriate value for gamma, as outlined in its draft determination, has significantly changed since this determination was published earlier this year.*
>
> *On this basis, the Authority confirms its position on the value of gamma as set out in its draft determination."*[45]

It would appear that the ERA has made two assessments about the same parameter three weeks apart and formed a different view on the appropriate gamma estimate to adopt in each, even though it relied on the same evidence. Moreover, in its TPI determination, the ERA explicitly rejected the notion that the AER had removed the uncertainty relating to an appropriate value for gamma. On this basis, the ERA's process appears to raise questions about its assessment process for gamma in the Western Power Draft Decision.

Evidence on gamma

The FIG is concerned about the ERA's reliance on the AER's conclusions in relation to gamma. In our view, the AER's decision to depart from its previously adopted value of 0.50 for gamma is flawed because:

1 the AER has accepted the advice of its consultant, Handley[46], that a dividend imputation payout ratio assumption of 100% is supportable. This is despite acknowledging that market evidence provided a support for an average distribution rate of 71%. The FIG understands that, in practice, there are technical impediments which exist within the tax rules on imputation, which mean that it cannot be assumed that all retained franking credits can be distributed[47]. Furthermore, it is not unusual for companies to either choose not to distribute franking credits for legitimate and sound commercial reasons, or to be prevented from effectively distributing retained credits for commercial reasons;[48] and

2 the AER has constructed its lower and upper bound range of values for gamma by taking the results of two different studies, Beggs and Skeels (2006)[49] and Handley and Maheswaran (2008).[50] There is no basis for treating the results of these studies as "constants" and

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[44] ERA, Final Determination on the 2009 Weighted Average Cost of Capital for the Pilbara Infrastructure ("TPI's") Railway Network, paragraphs 297-298.
[45] Ibid., paragraphs 312-314.
[46] J Handley, Further Comments on the Valuation of Imputation Credits, 15 April 2009.
[47] For example, there are rules which require all frankable dividends to be franked to the same extent (the benchmark rule) which means that companies are prevented from streaming franking credits to members who are best able to use them (anti-streaming rules). There are also numerous anti-avoidance measures to ensure that these rules are complied with.
[48] For example, companies may not be in a position to distribute retained credits at any point in time due to the need to re-invest.
[49] Beggs, D.J. and Skeels, C.L. (2006), "Market arbitrage of cash dividends and franking credits", Economic Record, 82, (258), 239-252.
[50] Handley, J., and K. Maheswaran (2008), "A measure of the efficacy of the Australian Imputation System", Economic Record, 84, 264, 82-04.

establishing a lower and upper bound in this manner. Given that the results of these two studies produce point estimates, a more valid basis to establish a range is to construct confidence intervals around the estimates. Using this method, it can in fact be shown that Handley and Maheswaran (2008)'s estimate of one dollar of imputation credit is not statistically significantly different from Beggs and Skeels (2006)'s estimate of 0.57.[51]

Given these flaws, it would appear that the AER's decision to depart from its previously adopted value for gamma of 0.50 was not sound. We therefore question the basis for the ERA's reliance on the AER's analysis to support its conclusions on the value of gamma.

5.2 Other issues with the ERA's decision that relate to investment risk

The FIG's has concerns with two other key aspects of the ERA's Draft Decision and the process by which it has formed its views. These relate to the implications associated with:

- development risk, and the retrospective optimisation of capital expenditure; and
- deferring revenue.

5.2.1 Development risk

Western Power has and continues to face an extraordinary investment environment, given the amount of development that is occurring, the lumpy investment demands it is imposing and the volatility of those demands. Moreover, as noted in Section 4, this is also true of infrastructure investment in Western Australia infrastructure more generally. Such development comes with additional:

- costs in terms of raising capital to fund the investments; and
- risks in relation to potential misjudgements of market demands and the timing of those demands, and the execution of capital expenditure decisions, particularly in tight labour and materials markets.

This development risk inevitably increases the cost of capital. There is considerable evidence to demonstrate that this is the case, including for example how the market values similar assets that take varying degrees of development risk, such as toll roads operators and toll road developer / operators, and property trusts that either own developed properties or develop and own such properties.

The retrospective optimisation of capital expenditure

Within this context, we note that the ERA has proposed to reduce Western Power's proposed opening value of the capital base for the second access arrangement period by $474 million. We understand that the majority of this (around $345 million) is the result of a 15 per cent

[51] Skeels, C.L., Estimation of γ, Department of Economics, University of Melbourne, 18 June 2009 (unpublished paper).

reduction of value of the new facilities investment (other than that comprising of gifted assets) to reflect likely inefficiencies in undertaking the investment.

The FIG understands that the ERA may have the power to retrospectively optimise Western Power's capital expenditure, and it has no views on the efficiency or otherwise of Western Power's capital expenditure. The FIG nevertheless believes that the retrospective assessment of capital expenditure is not consistent with providing incentives for efficiency, nor the certainty necessary to encourage investment.

The FIG also has some concerns with the ERA's approach as it fails to:

- take into account the market circumstances in which Western Power has been operating, as described above; and
- explain why this approach, and the way it is applied, is consistent with the Access Code and good regulatory practice (the effect of which is to create additional regulatory uncertainty); and
- pay regard to the risks its approach creates more broadly.

In relation to the third point, the FIG firmly believes that retrospective optimisation of capital expenditure cannot occur without imposing additional risk on the business, particularly as the ERA has applied it. We note in this regard that, under the National Electricity Rules, there is no scope for optimisation and that the AER has explicitly identified this as an issue which is "highly likely" to reduce exposure to systematic risk.[52]

The additional risks that the ERA's use of such an approach creates is likely to be manifested in WA infrastructure businesses having to bear a higher cost of debt and higher costs associated with raising equity. It could also lead to investors seeking pre-approval of capex projects from the ERA to ensure roll-in, which would not only lead to delays in investment, but also raise the costs of project approvals.

5.2.2 Deferring revenue

The FIG notes that the Draft Decision includes approximately $407 million (in present value terms) of target reference service deferred revenue.[53] By contrast, Western Power's proposal included approximately $178 million. The Draft Decision also proposes an amendment to allow for the recovery of this deferred revenue in the next access arrangement period.

This approach by the ERA to deferred revenue is justified on the basis of avoiding a price shock. Section 6.4(c) of the Access Code includes this as one of the objectives for the price control. Price shocks are described as *"sudden material adjustments between succeeding years."*

[52] AER, Final Decision, Electricity transmission and distribution network service providers, Review of the weighted average cost of capital (WACC) parameters, May 2009, page 248-249.

[53] Prior to any tariff equalisation the Government might provide for. The deferred revenues relate or have been tied to changes in the approach to capital contributions, although the reasons for this are not apparent.

The FIG understands the unusual circumstances that exist in relation to network electricity pricing in Western Australia, which are driven primarily by capital expenditure. It is, however, of concern that the ERA:

- has not been transparent in how it has made its decision on what represents a price shock;
- proposes to apply it without of any consideration of the impacts on downstream markets (e.g. the competitiveness of gas compared to electricity); and
- seems reluctant to take into account the same circumstances in other aspects of its decision (e.g. when assessing the development risk to which the business is exposed).

This approach to decision-making on such an important variable would again appear to be inconsistent with providing regulatory certainty.

6 Conclusions

In summary, the FIG considers that the ERA's conclusions on the cost of capital, if perpetuated in its Final Decision, will lead to returns that are inadequate to support much-needed investment in energy network infrastructure in Western Australia, particularly in light of the fall-out from the Global Financial Crisis.

We have identified that the ERA's Draft Decision contains numerous fundamental anomalies and inconsistencies in how it has derived its views on various parameter values, which would appear to have contributed to its erroneous conclusions. The Draft Decision is not therefore soundly based and introduces significant regulatory risk for the owners of regulated infrastructure in Western Australia.

A The Financial Investor Group

The FIG is an affiliation of eight major investors in Australian energy transmission and distribution networks. It includes: The APA Group; Babcock and Brown Infrastructure; Cheung Kong Infrastructure; the DUET Group, which is jointly managed by AMP Capital Investors and the Macquarie Group; Hastings Funds Management; Hongkong Electric; Singapore Power International; and Spark Infrastructure.

In addition to their energy interests, FIG members own significant other infrastructure interests, including in:

- non-regulated energy, transport, roads and water sectors; and
- infrastructure investments in Asia, New Zealand, North America, the United Kingdom, and elsewhere in Europe.

Table 1 provides some details on specific energy interests of the five members of the FIG who have contributed to this submission.

Table A1: Description of key assets of the members of the FIG making this submission

Investor	Description of key assets
The APA Group	Manager of a listed energy infrastructure vehicle with interests in more than 12,000 km of gas transmission infrastructure, a gas distribution network in Queensland, two high voltage direct current electricity interconnector systems, other energy related assets and a 19% stake in Envestra.
Babcock and Brown Infrastructure	Listed energy and transport infrastructure vehicle with energy investments in the transmission and distribution sectors. Assets include interests in Western Australia Gas Networks, Dampier to Bunbury Natural Gas Pipeline, Multinet Gas Network, Tasmanian Gas Pipeline and Westnet Energy. It also holds interests in a number of offshore assets including Powerco and the Cross Sound Cable and the Natural Gas Pipeline Company of America.
DUET Group	Listed energy infrastructure vehicle which has interests in Western Australia Gas Networks, Dampier to Bunbury Natural Gas Pipeline, United Energy Distribution, and Multinet Gas. Also has an interest in Duquesne Light, an electricity transmission, distribution and supply business in Pittsburgh, USA.
Hastings Funds Management	Manager of a range of listed and unlisted energy and other infrastructure vehicles, wholly owned by Westpac Banking Corporation. Its energy infrastructure includes interests in ElectraNet and Epic Energy. It also owns interests in water assets in the UK.
Singapore Power International	Owns and operates electricity and gas transmission and distribution businesses and provides energy market support services in Singapore and Australia. In Australia, SP Group owns SPI (Australia) Assets a diversified energy utility company whose assets include the former assets of Alinta and United Energy Distribution, and 51 per cent of SP AusNet, an owner and operator of electricity transmission and distribution networks and gas distribution assets in Victoria, Australia.

APA Group

BABCOCK & BROWN INFRASTRUCTURE

DUET GROUP

Hastings Funds Management

SINGAPORE POWER

The Financial Investor Group

Supplementary submission to the ERA regarding its Draft Decision on Western Power's Proposed Revisions to the Access Arrangement for the South West Interconnected Network

Revised Final Version 22 October 2009

FIG's Concerns with the ERA Western Power Draft Decision

The draft ERA WACC is below the precedents set in the AER Statement of Regulatory Intent

Even the AER WACC parameters result in returns that are well below the observed practical cost of equity capital

Inadequate returns on existing assets creates pressure on maintenance capex budgets and consequently impacts asset/network performance

Uncompetitive returns will see capital re-allocated to regulated assets in other jurisdictions or unregulated sectors

- further increasing the cost of raising new equity
- reducing funding available for growth/expansion

The Draft WACC results in returns materially lower than the observed practical cost of equity

Investor requirements for returns from the existing asset base are reflected by;

- the trading yield
- plus projected capital growth

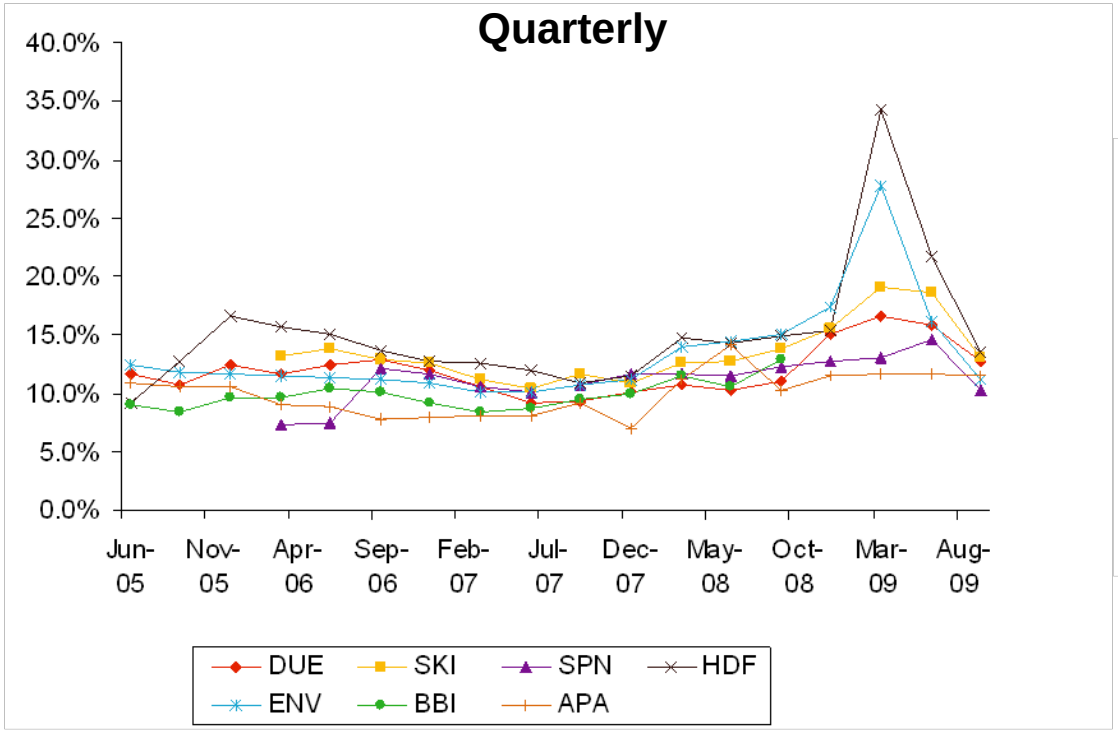
Investors are demanding material discounts for new equity capital

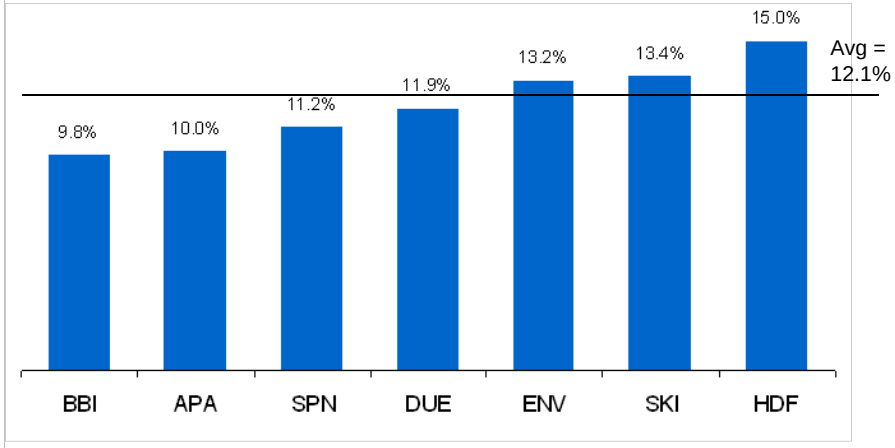
The observable cost of equity for Australian regulated utilities is around 15% pa

- 11-15% for existing equity
- 15-18% for new equity

Trading yields have historically been 10-15%

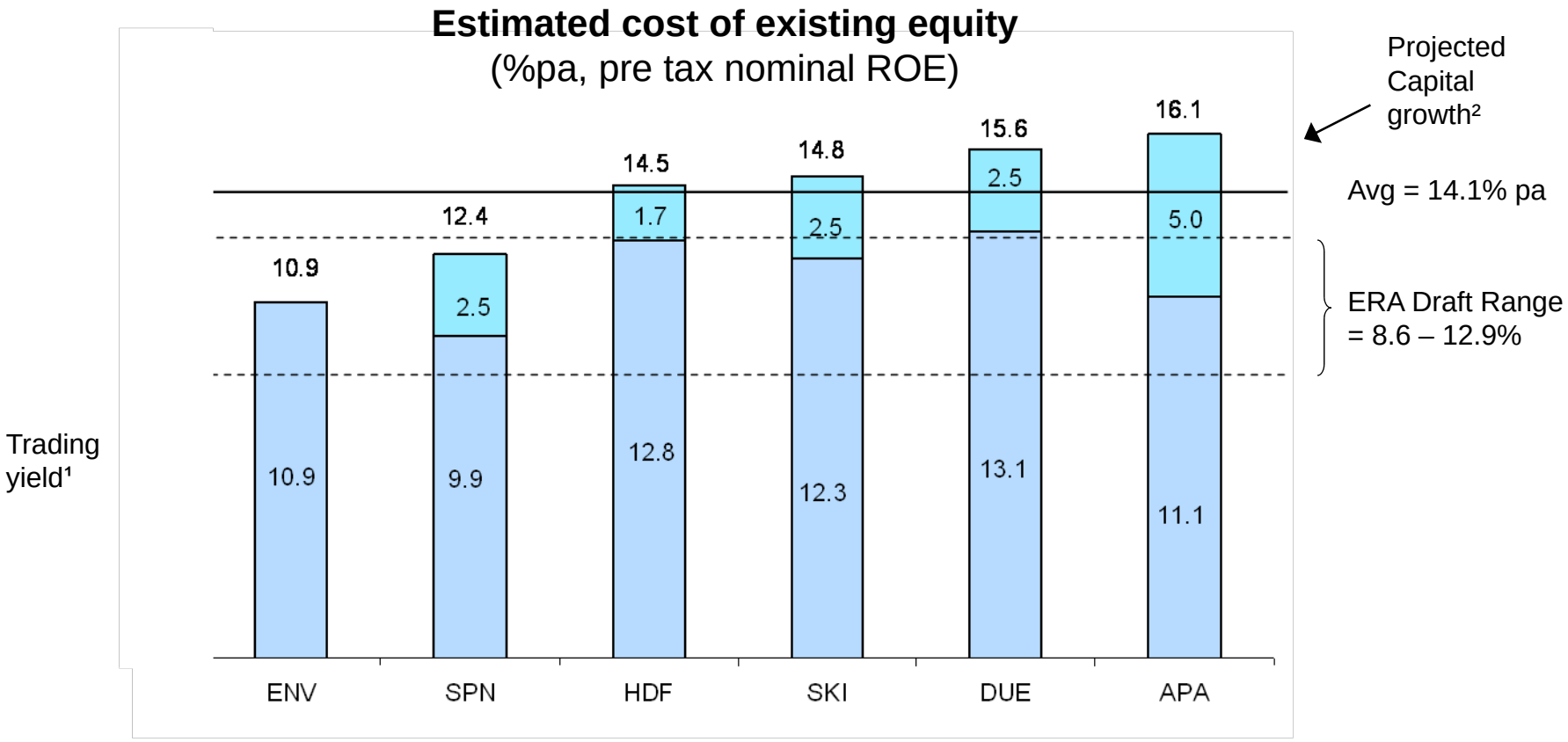
Prospective Trading Yields
(dividend guidance/quarterly VWAP)





Source: Bloomberg

Investors currently expect a return of 11-15% pa on existing assets



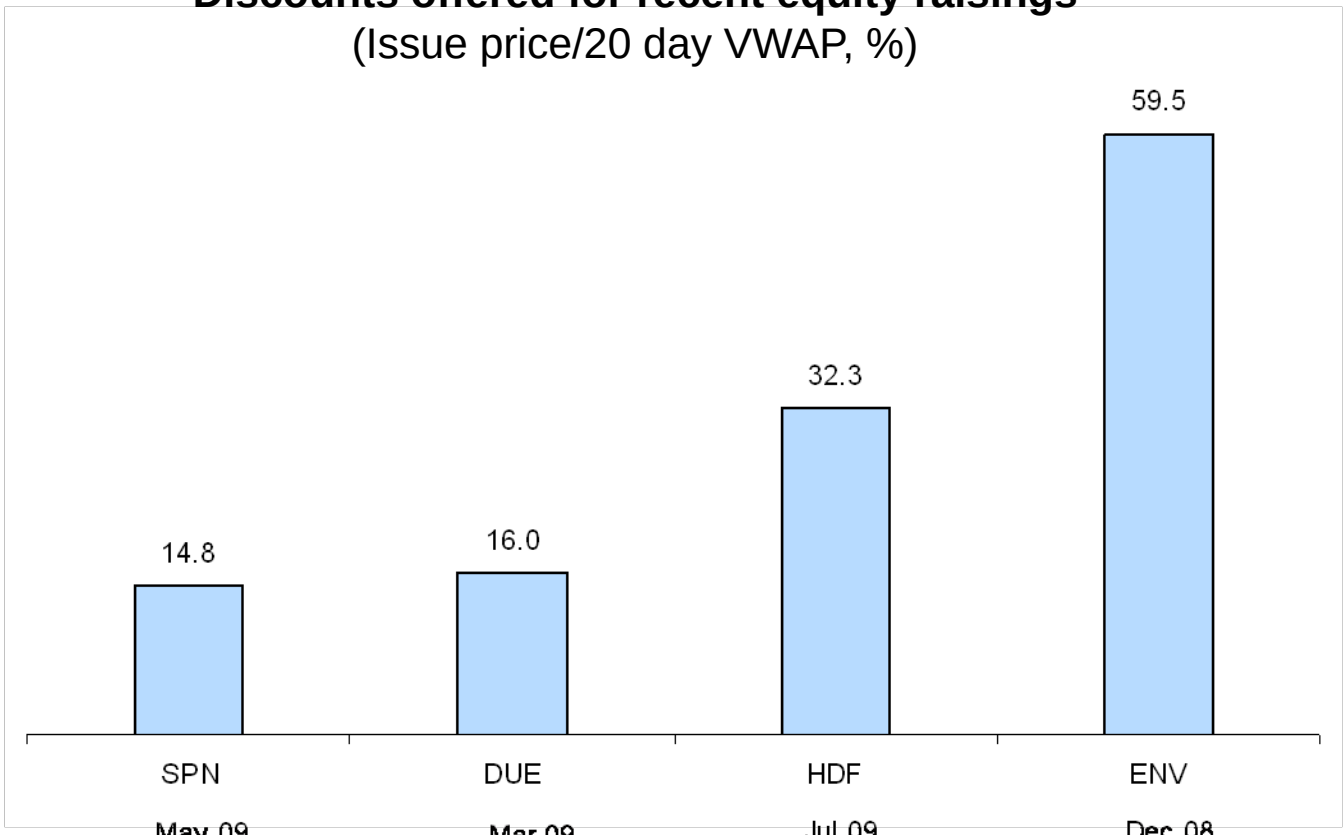
¹ Source: IRESS and company announcements (prospective dividend on market capitalisation as at 9 September 2009)

² Source: RBS (projected 3 year DPS growth)

New Equity has been issued at material discounts

Discounts offered for recent equity raisings

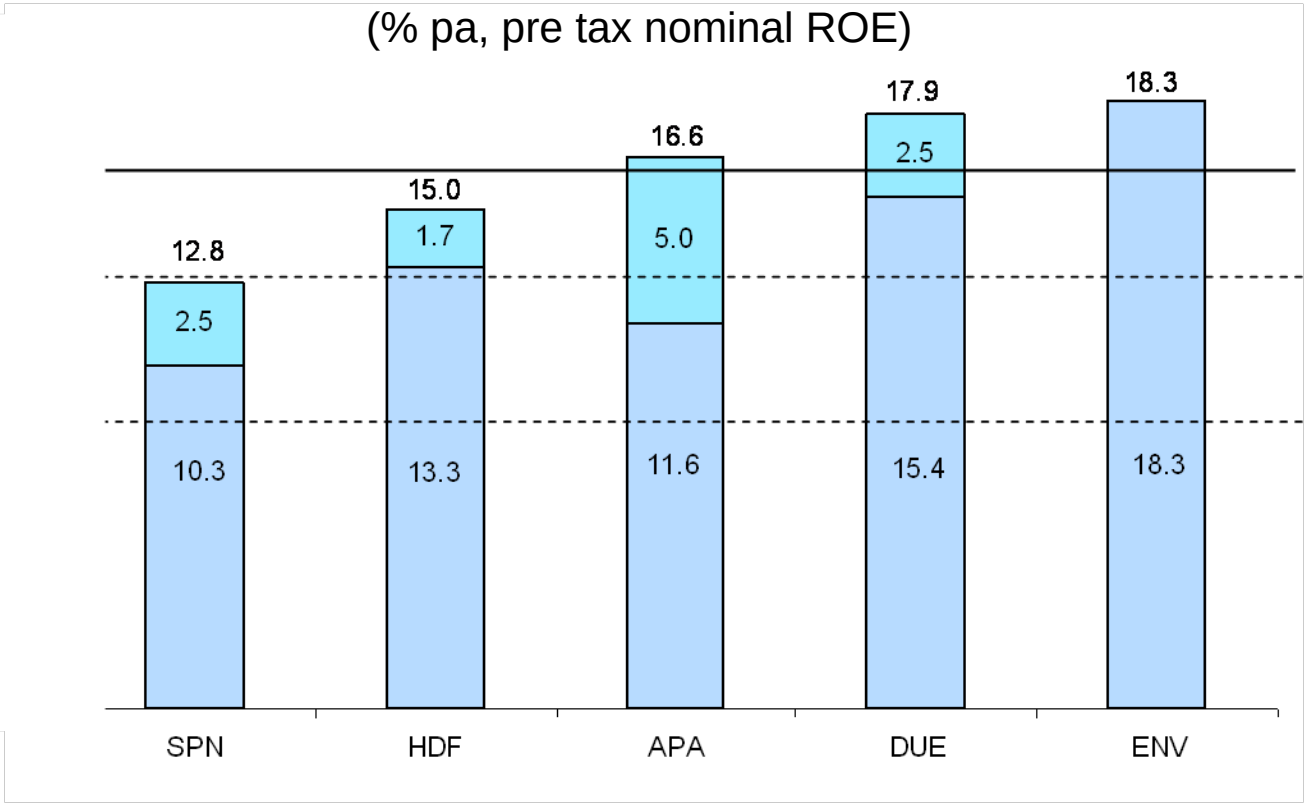
(Issue price/20 day VWAP, %)



Source: IRESS and company announcements

The cost of new equity is currently 15-18% pa

Implied cost of new equity
(% pa, pre tax nominal ROE)



¹ Source: IRESS and company announcements (issue price over market price at time of announcements)

² Source: RBS (projected 3 year DPS growth)

Conclusion

The observed practical cost of equity for Australian utilities is materially higher than that implied by the ERA or the AER WACC proposals

- existing assets require returns on equity of 11-15% pa
- new equity capital needs to generate at least 15-18% pa

The consequences of applying the ERA or AER precedents could be very material

- minimisation of replacement and maintenance capex
- increasing average asset age and deteriorating efficiency and performance
- lack of new equity and debt capital to fund network upgrades and to meet demand and growth expectations