

UC Draft Decision: Price Control Mechanism – NTMEU Response

The Northern Territory Major Energy Users (NTMEU) have now examined the utilities Commission's Draft Decision Paper on Price Control Mechanism. We note that responses were sought by 18 April 2008, and we apologise for our late response.

The NTMEU generally agrees with the Commission's proposed approach, including in particular the proposal to scrutinise Power and Water's proposed network pricing principles and methods statement and a base year cost review. We believe that a rigorous examination will be necessary as part of the UC's network pricing review of Power and Water.

The NTMEU is very disappointed that the UC has taken a decision to apply the WACC parameters required to be used by the AER for the NSW/ACT interim distribution review. We would note that the setting of these WACC parameters this was not a formal decision taken as part of the review of the Distribution Rules led by MCE SCO, but unilateral decisions made by the NSW and ACT Governments without reference or discussion of the matter

The setting of the WACC parameters is a fundamental issue with considerable financial implications that should be appropriately left for the review to seek stakeholder views, as well as independent advice. As it is, the WACC parameters to be adopted are considerably in excess of what consumers and financial markets consider appropriate for regulated monopoly electricity and water businesses, particularly the adoption of an equity beta of 1.0. The UC decision confers an excessive premium to Power and Water at the expense of consumers. We believe the UC has erred on this issue and should review this matter again, or at the very least allow for offsetting adjustments. We have attached a brief paper discussing in more detail our concerns regarding the WACC development and its inputs.

Yours sincerely

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Chairman
NT MEU

Attachment to NTMEU letter

Responding to

UC draft decision on price control mechanisms

WACC elements

Risk free rate

Dependent on the approach used by the regulator to set allowable revenue, the issues raised by NERA on behalf of the regulated networks that due to the increasing scarcity of indexed bonds, there is now a clear and accepted disconnect between indexed and nominal CG securities. It is generally accepted that the nominal bonds have sufficient supply to constitute adequate market depth as to provide the best estimate of nominal risk free rate. The scarcity of indexed bonds implies that there is a premium for their acquisition and so the resulting implied return is seen as showing a discount to the real risk free rate.

Thus the key is to whether the regulator intends to use as its approach to setting the WACC in nominal terms and so developing a nominal cashflow basis for the building block (as does the AER) or whether it intends to use a real WACC and to set a real cashflow for the building block (as does the Victorian ESC).

Dependent on the approach, the estimation of inflation then becomes either critical or less important.

If the nominal approach is used (following the practice of the AER) then estimating future inflation becomes less of an issue. The nominal approach uses the accepted nominal CGS as the risk free and inflation is assessed to adjust the expected cash flow. As the regulators require the regulated business to adjust its revenue on actual inflation during the period, the error introduced by using an incorrect inflation forecast is basically corrected on an ongoing basis.

If however the regulator uses an approach using real WACC, then assessing the future inflation becomes critical. Underestimating future inflation will give the regulated business a windfall revenue benefit (effectively increasing the return above the target return developed by the CAPM). Equally overestimating future inflation will penalise the business. As regulators have a basic approach to regulation that, where

there is potential doubt, they bias their decisions towards the regulated business, it is probable that using a “real” approach to the revenue setting, will provide an unearned benefit for PWC.

The NT MEU considers that the UC should follow the AER practice and use a nominal approach rather than the “real” approach used by others. By doing so this will maintain a higher degree of equity and reduce the debate as to what is the likely level of inflation over the regulatory period.

Inflation

The general acceptance is that the indexed CGS rate is deflated in yield due to a scarcity factor but that the nominal CGS yield is a good basis of the “risk free rate” means that regulators have to secure very sound input to inflation over the coming regulatory period in order to set a soundly based risk free rate. The ACCC has assessed the inflation requirement as 3%.

If the nominal rate is accepted as being a reasonable assessment of the risk free rate, then the selection of the inflation rate become critical to the development of the “real” risk free rate that is used to develop the revenue requirement for the regulated business.. This then requires considerable effort to forecast future inflation

In fact, this might not be as challenging as first thought. Analysis of the yields for different duration bonds seems to imply that the inflation expectation built into nominal bonds is not reflective of the duration of the bond – that is, the inflation forecast the market builds into the bonds is much the same for short term bonds as for long term securities. As noted by the AER in its assessment of SP Ausnet the implied inflation derived from inflation swaps indicates an inflation estimate of 3.37% (page 123)

“Inflation swaps

On the 6 August 2007, Bloomberg displayed the prevailing rate on a 10 year inflation swap to be 3.37%. This rate essentially represents the mid price at which the market is buying/selling 10 year inflation contracts based on CPI. The AER notes that whilst inflation swap rates give an estimate of the price at which firms can hedge inflation risk, they may not necessarily indicate the market’s expectation of inflation. The swap rate is likely to include a positive or negative inflation risk premium, though of an unknown magnitude. The AER does contend though, that whilst inflation swaps may not produce the best estimate of forecast inflation, the prevailing rate on the 10 year inflation swap does support a general inflation forecast of 3%, as opposed to 2% or 2.5%. This conclusion is drawn from the analysis that if an inflation forecast of 2.0 % or 2.5 % was

determined, the current yield on inflation swaps would indicate that these inflation swaps include a positive inflation risk premium in the order of 137 bp or 87 bp, respectively.

These observations then add considerably to the debate, as the observations imply that the market is not forecasting inflation over the duration of the life of the security, but the inflation seen in the short term only. The repercussions of this are profound in an environment where there is definite concern that indexed CG securities are being overvalued (ie understated in yield) due to their relative scarcity.

In its final decision on GasNet in 2002, there was considerable debate as to the duration of bonds to be used for the risk free rate. The ACCC identified that the inflation derived from 5 year indexed and nominal bonds was the same as that derived from 10 year bonds (page 89). If different duration bond yields have essentially the same inflation component, then it is incorrect to assume that the difference between nominal and indexed securities provide an inflation figure which is expected to apply for the entire regulatory period; it becomes then an assessment of what the short term inflation is likely to be. This short term figure is then the adjusting amount that should be used to convert nominal bond yields to "real" bond yields.

In the past regulators used indexed bonds to set the "real" risk free rate – this was a correct approach and provided an independent market derived basis for inflation. They used the difference between the indexed bond and the nominal bond to set a forecast for inflation to develop the revenue requirement. If this forecast was incorrect, there was no residual impact on the regulated business as the business was able to adjust its revenue during the period to match actual inflation.

In the post indexed bond era, setting inflation for the revenue requirement still remains as it was – the revenue is adjusted annually to reflect actual inflation and so is not a major issue if it is not quite right.

However, for setting the risk free rate which is the basis of the revenue requirement, setting the inflation rate too low will give the regulated business a windfall profit. Setting the inflation rate too high will result in the business having too low a revenue stream.

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The RBA has assessed that the current and forecast inflation for the economy is as shown on the following table; this table is from of a series of the quarterly bulletins from the RBA¹ about the economy.

	Sep 2007	Dec 2007	June 2008	Dec 2008	June 2009	Dec 2009	June 2010
GDP	4.3	3½	3¼	3¼	3	3	3
Non-farm GDP	4.5	3¾	2¾	2¾	2¾	3	3
Consumer price index	1.9	3.0	3½	3½	3¼	3¼	3
Underlying inflation	3.0	3.6	3¾	3½	3¼	3¼	3

(a) Actual GDP data to September 2007 and actual inflation data to December 2007. Underlying inflation refers to the average of trimmed mean and weighted median inflation. For the forecast period, technical assumptions include A\$ at US\$0.89, TWI at 69, cash rate at 7.0 per cent, and WTI crude oil price at US\$86 per barrel and Tapis crude oil price at US\$90 per barrel.
Sources: ABS; RBA

Thus if the nominal bond rate includes only for short term inflation expectations (and after some thought, intuitively this would be the expectation) then the ACCC should use short term assessments of inflation for developing the “real” rate from the nominal rate.

The NTMEU recommends that the UC use the as the inflation rate to convert nominal bonds to the “real” risk free rate of 3.50%.

If a nominal approach to revenue setting is used, the UC should use the expected long term inflation rate for the basis of developing the revenue stream, as the setting of the inflation rate for this purpose is not critical and is adjusted annually to actual inflation throughout the regulatory period.

Credit rating

In the Chapter 6A Rules (which is the basis for the WACC elements used in the NSW/ACT derogation) the AEMC set a credit rating of BBB+ based primarily on an assumed gearing of 60debt: 40equity. Historically the ACCC had used a credit rating of A for transmission businesses, and so had jurisdictional regulators.

¹ RBA STATEMENT ON MONETARY POLICY – February 2007, table 15. The expectation is that the RBA will continue to provide this information on a regular basis so that independent assessments of inflation are available.

The AER is required to develop a new set of WACC elements for 2009 (for both transmission and distribution) and presumably it will use actual market data at the time to quantify any changes. The NTMEU considers that there is no substantive reason that as PWC is a government owned corporation it should not be granted the same credit rating held by its owner. To use a lower level is tantamount to providing a windfall benefit to PWC, and effectively imposes taxation on electricity consumers.

Equity beta

By the UC determining that it intends to use the NSW/ACT derogation from chapter 6 for the CAPM elements, the UC is not using latest market data to assess what levels should be used. The NTMEU affiliates in other jurisdictions have consistently maintained for many years that an equity beta of unity is too high, and has provided evidence that the Utilities sector as a whole operates at an equity beta of 0.7 or lower.

This lower figure is based on direct experience of utilities businesses operating in Australia since 2001. In 2001 there was introduced a new asset class into the ASX subsectors, and there is now some seven years of data available. It has only been in the last 2-3 years that sufficient data has become available on which to assess Utilities independently of other asset classes.

Jurisdictional regulators have used lower equity betas for electricity and gas distribution businesses in the last three years. In SA the local electricity distribution business (ETSA) was given an equity beta of 0.8 by ESCoSA, but on appeal this was increased to 0.9 despite the government considering 0.8 was appropriate. The reason for the success of the appeal was not on the merits but on the issue of regulatory practice and that an equity beta of 0.8 was well beyond previous regulatory decisions although the QCA and IPART had previously used equity beta values of less than unity. ESCoSA used an equity beta of 0.9 for the subsequent gas distribution decision with an observation that gas distribution possibly had greater risk than electricity distribution. A year later in Victoria the regulator settled on an equity beta for gas distribution for current conditions in the range of 0.5-0.8 which was fixed at 0.8. In particular the analysis of the Victorian regulator was extraordinarily detailed.

The decision to derogate the NSW/ACT CAPM inputs was driven by the owning governments prescribing these values, despite a view provided by MCE SCO that this was not perhaps the most appropriate route. At worst, the government decision can be seen as self serving in the extreme and not in the long term interests of consumers.

The NTMEU considers that the decision to use the derogated CAPM Inputs to be a “cop out” and the UC is conferring an unnecessary premium of cost onto consumers. There is now compelling evidence developed by two jurisdictional regulators (and upheld in the appeal in the case of the SA decision) that an equity beta of 1.0 is too high. For its final decision on GasNet in 2002 the ACCC was provided with evidence that an equity beta of 1.0 was too high and the ACCC commented that (page 109)

The UC has now been provided with evidence that an equity beta for electricity (and gas transport) businesses at 1.0 is too high, and that a lower figure should be used. **The UC must, if there is sustainable evidence, use a contemporary assessment of equity beta.**

That the jurisdictional regulators in SA and Victoria have done so and reduced equity beta for electricity and gas distribution, there must be strong evidence that the equity beta for PWC at 1.0 is too high, and must be reduced.

Conclusion

The NTMEU considers that the UC should not arbitrarily use the derogated CAPM inputs to be used for the NSW/ACT electricity distribution reviews. It should provide its own assessment and use contemporary data as the basis for the values it does intend to use.