Submission to AER Enquiry

Thank you for the opportunity to comment on the methodology used to calculate the price of electricity. The largest component of this price is a return on the network assets which is determined by calculating the weighted average cost of capital (WACC) and then applying it to the depreciated value of the network assets. The WACC includes a risk-free rate plus an estimate of the risk premium needed to attract investors to the firm.

The current system distorts incentives for the efficient allocation of capital. The government owners of the DNSPs can borrow at the risk-free rate, overspend on infrastructure and receive a much higher rate of return. The regulator, in this case the AER, has a duty to ensure that the DNSPs are adequately financed for OPEX and CAPEX. It also ensures a return of capital by way of a depreciation component in the regulated price. This effectively means that there is no market risk as there are no uncertainties with regard to their ability to operate profitably and return equity to investors. There is a small regulatory risk that the rules may change or the regulator may miscalculate but this is highly unlikely.

QCA has a discussion paper on its website http://www.qca.org.au/getattachment/2ec54eab-9065-4d67-8662-68b426fe316b/Split-Cost-of-Capital.aspx describing a split cost of capital approach to calculating the WACC. The concept was developed by Professor Dieter Helm (Oxford) and he describes it in the following terms;

"The risks of the RAB are very low as long as the regulator commits to honouring the investors' corresponding commitments which the RAB embodies; whilst the risks of the OPEX and the carrying out of the CAPEX are considerably higher. An average cost of capital is too high for the RAB and too low for the OPEX and CAPEX. It therefore distorts incentives, encourages gearing to exploit the higher return on the RAB relative to the risk, and raises the overall cost of capital because of the lack of clarity on the status of the RAB and the uncertainty about the treatment of the CAPEX once completed. It does not yield the correct marginal incentive to CAPEX."

The result of this strategy is a rate of return for the RAB equivalent to the risk-free rate plus a small premium for regulatory risk .... in total about half the current WACC.

The privately owned DNSPs in Victoria do not appear to be listed on the ASX as they are subsidiaries of other companies. Where they have been privatised in the UK their market capitalisation value is much higher than their RAB. This suggests that the private investors' required rate of return is lower than that set by the regulator, i.e. the market risk premium has been overvalued.

There is no doubt that a split cost of capital approach will lower the revenue received by the DNSPs and will be resisted by management if they overlook the crucial point that it also lowers the risk profile of the entity and therefore the cost of doing business. Failure to acknowledge this would indicate that the current arrangement is an exercise in rent seeking. The return on CAPEX will be

higher to reflect the real risks incurred during the construction phase. This ensures that necessary infrastructure is built but removes the incentive for gold-plating as it is rolled over into the RAB soon after completion.

It is important that electricity is correctly priced as it is a component of everything that is produced in this country. If it is priced too high it becomes a tax on doing business. For it to be priced correctly it has to be costed correctly using the split cost of capital approach to calculate the WACC.

Yours faithfully

RA Mackenzie