



Mr Alan Johnston
The National Access Inquiry
Productivity Commission
PO Box 80
Belconnen ACT 2616

Dear Mr Johnston,

Re: NERA's Submission to the Productivity Commission (DR120)

I am writing in response to the submission made by NERA on 17 August, in which it is claimed that comments made by NECG in our submission entitled 'International comparisons of rates of return' (DR107) are "at best misleading and, in some cases plain [sic] wrong".

We firmly reject these assertions, and would like to take the opportunity here to respond to NERA's main criticisms.

(a) Selectivity and bias

NERA say that they were asked by the ACCC to "survey post-tax rates of return for gas and electricity distribution businesses in North American and the United Kingdom". This may well be the case, however, we note that their report has been used by the ACCC on a number of occasions to justify the ACCC's decisions in a much broader context. It is also clear that the manner in which NERA's report is written deliberately invites this interpretation, with large parts of the report appearing to imply that inferences for regulated industries as a whole might be drawn from the analysis. To give one obvious and important example of this, the Executive Summary talks exclusively of Australian "regulators" setting higher rates of return than North American and UK "regulators" without at any point explaining that this means "energy regulators". It is also strange that the table summarising NERA's findings should include (very harsh) decisions from the UK water industry – especially when, in its letter to you, NERA says that the water decisions were only considered to throw light on the issues regarding tax. Had it been NERA's intention to make it clear that the Report was in fact confined to comparisons with respect to energy, it would have been reasonable to expect this to be clearly flagged in the over-view of the work being reported on.

Even more importantly, the Commission will also be aware that the ACCC's submission to the review of the national access regime dated 29 June (DR93) cites NERA's report as evidence that:

Arguments that the rates of return allowed by regulators are too low to encourage new investment seem to be based on opinions rather than evidence

The ACCC go on to quote conclusions from the NERA report. **At no point does it say that these conclusions come from a study with a mandate limited to particular regulated industries**; rather, the findings are presented in very general terms, as when the ACCC says:

...Australian regulators are, if anything, declaring higher vanilla post tax WACCs than in other jurisdictions examined. Purely based on the declared returns examined in this survey, Australian regulators appear to offer approximately the same or higher returns than North American regulators who in turn appear to offer significantly higher rates of return than in the United Kingdom.

Indeed, it is only **after** NECG's Submission that a published or public statement of the ACCC has made it clear that the comparisons being made rest on a highly limited sample. In this respect, our concern that NERA's conclusions are based on a selective and biased sample, which lends itself to being used, and indeed has been used, to create the impression that best practice in the UK is consistent with a set of very aggressive determinations by just two of the seven economic regulators in that country, is certainly valid.

We believe that our inclusion of the aviation, rail, telecommunications and water sectors presents a far more balanced picture of regulatory experience across the full range of industries that the Productivity Commission is considering during its review. We also note that when the broader sample is examined, the claim that Australian regulators are setting higher rates of return than their UK counterparts is seriously weakened.

(b) Omitted analysis of country specific risks

NERA's submission disputes our evidence that differences in country-specific risks can explain a significant proportion of the differentials between jurisdictions. We find it hard to understand why NERA takes this view.

With regard to the artificially low risk-free rate in the UK over the last three years—a phenomenon which has influenced recent decisions by all of the UK regulators, including the Competition Commission—we note that more than half of the decisions examined by NERA in Tables 1.0 and 4.1 are based on estimates of the real risk-free rate of 3% or below. Since interest rates are currently significantly higher in Australia (by at least 0.5%), it is quite appropriate to point out that Australian utilities cannot be expected to raise new finance in dollar-denominated markets at the returns allowed recently for UK companies.

The second argument we made in our submission is that differences in sovereign risk account for a large proportion of the differentials in allowed rates of return. Figure 2 in our submission, which uses data over the period 1979 to 1995, shows that expected market returns from equity markets for the US are lowest (14.4%), expected returns for the UK are marginally higher (14.7%), but that expected returns for Australia are significantly higher at 16.9%, and that there is clear correlation with countries' credit ratings.

NERA, in their submission to the Productivity Commission, simply question whether these differences might be properly reflected in the risk-free rate or the equity-risk premium, not that differences in underlying sovereign risk can account for differences in equity returns in the three jurisdictions. Although this matter is irrelevant to the conclusions we draw from the analysis (ie, that it is appropriate for the allowed cost of equity in the three jurisdictions to mirror the observed differentials), we believe NERA are quite wrong to assert that country specific risks are not captured by measures of the equity-risk premium.

It is also worth pointing out that sovereign risk is not the only factor influencing differences in returns in the three equity markets. For example, a forthcoming paper by Professor Jerry Bowman ‘Estimating the Market Risk Premium: The Difficulty with Historical Evidence and an Alternative Approach’ argues that differences in the composition of equity market indices exposes Australians holding a market portfolio to greater risk than holders of the US market portfolio (which is made up of larger and less risky firms). His calculations suggest that the equity-risk premium in Australia will, as a result, stand at between 1.5% and 3.75% in excess of the equity-risk premium in the US, a conclusion that is consistent with the differential we have identified in expected equity market returns.

(c) Omitted differences in the three regulatory regimes

NERA’s submission argues that NECG is wrong to place so much weight on the relationship between regulators’ approaches to asset valuation and cross-country differentials in allowed rates of return. It appears to suggest that other (unspecified) factors will offset the impact of different asset valuation methodologies on the cost of capital, and that there is no reason to make any allowance for these types of cross-country differences in their analysis.

We do not find this convincing. Having identified different returns in the three jurisdictions, we consider that it is necessary to identify whether the regulatory regimes expose investors to different levels of risk, thus explaining any differential. NERA itself admits that it ‘examined only one of those factors in detail’ (tax) and NECG have simply added a detailed analysis of what we consider to be the most important omitted variable.

We also note NERA claim that, in the energy sector, the risk of investment stranding is ‘more imagined than real’, and that ‘the Australian Gas Code offers a relatively high degree of assurance that asset values will be consistent between one regulatory period and the next’. This is not something that is apparent to companies or their investors, as the Productivity Commission will be aware from the submissions it has received during its review.

Indeed, section 8 of the Gas Code makes it abundantly clear that regulators are quite entitled to reduce a business’s regulatory asset base (RAB) in the event that market conditions change over time:

- section 8.27 of the Code allows a regulator to remove from the RAB ‘Redundant Capital’ associated with assets which cease to serve, or which provide reduced service;
- section 8.19 of the Code contains a provision to deal with oversized facilities, by setting aside the cost of oversizing in a Speculative Investment Fund, which is not included in the RAB unless and until the additional capacity is used.

As Professor Tom Parry, Chairman of IPART, said on August 18th, during a presentation to Trade Practices Workshop run by the Law Council of Australia, “the (Gas) Code offers the regulator more discretion than one might think”. Professor Parry’s statement was made in response to a comment that claimed, just as does NERA, that the Code provides certainty with respect to asset valuation.

Before making use of these provisions, the regulator is required to take into account the uncertainty that such a mechanism would cause and the corresponding impact on the cost of capital. To the extent that changes in technology and demand are predominantly systematic risks, the effect of these arrangements is unambiguously to increase the required rate of return.

Indeed, we note that the Commission expressed precisely this view in their Position Paper when they discussed the DORC approach:

...one implication of this transfer of risk to asset owners is that they will require a higher rate of return than under a DAC valuation.

When one considers that companies outside the energy sector, particularly in rail and telecommunications, face a similar risk of asset stranding under the DORC/TSLRIC approaches, it is extremely odd that NERA do not consider this to be a relevant consideration.

As a final observation, we note that this is a very different position from the one that Transco finds itself in. As we explained in our submission, Transco experienced a one-off reduction in its RAB in 1997 when its regulator changed the methodology through which it valued assets held at vesting. Although there has been considerable debate about whether this decision was correct (a debate which is very specific to this individual firm), the risk that there will be further adjustments to the RAB in future is really a form of regulatory risk. Partly reflecting concerns about this risk, and the controversy caused by the 1997 adjustment, the UK regulatory agencies have sought to minimise the uncertainties going forward. Indeed, the degree of certainty in Transco's regulatory regime was confirmed again in Ofgem's recent draft proposals for prices in 2002–07, when the regulator simply rolled forward the asset valuation established in 1997.

The fact is that the 1997 Transco decision stands out as something of an anomaly in almost 20 years of regulatory decisions in the UK. The controversy it provoked, and the attitude adopted in the most recent review, make it clear that this is an exception that virtually confirms the rule – that rule being that the simple roll-forward approach is almost always adopted by UK regulators. A simple regulatory approach to these issues, providing a degree of certainty, is not something that Australian gas companies anticipate happening to them when they read sections 8.19 and 8.27 of the Gas Code. It is even less true with respect to regulated industries other than gas: for example, as the Productivity Commission knows, the ACCC has modified its valuation of Telstra's assets on just about each occasion on which it has considered this issue – a far cry from a regime providing any certainty to investors.

In summary, we believe that the conclusions reached in our submission stand. If the NERA Report had a limited mandate, the Report itself (which in its key Table sets out data with respect to an industry NERA now says it did not have the mandate to cover) does not act to make that plain. More importantly, accepting that NERA had such a limited mandate, the fact that the conclusions it reaches do not withstand the extension of scrutiny to a wider sample makes the ACCC's use of NERA's Report, most visibly in its Submission to the PC, all the more inappropriate.

At the end of the day, the ACCC has sought to rely on the NERA Report to defend conduct that the facts at issue cannot defend. Indeed, it is striking, and somewhat depressing, that the ACCC continues in this course of action. Thus, in a letter to the Australian Financial Review dated August 23rd 2001, Professor Fels seeks to respond to concerns expressed by Foxtel in respect of regulatory price determinations. Professor Fels, in arguing that the rates of return allowed by Australian regulators compare well internationally, cites the NERA report, though he now acknowledges that its results refer to energy industries. What Professor Fels does not say, and given that he was writing in respect of telecommunications, could and should have said, is that the Beta the ACCC has allowed to Telstra is far below that determined by OFTEL in respect of BT. As a result, the overall allowed WACC, when stripped of its narrowly country-specific factors, is hardly such as to give Foxtel any degree of comfort – quite in contrast to what Professor Fels implies. Here again, the ACCC seems to rely on partial, potentially misleading, comparisons in considering matters that surely merit proceeding with the greatest care. The ACCC's considerable influence, well-deserved standing, and statutory responsibilities only underscore this assessment.

It is for this reason that NECG has sought to more carefully analyse the relevant facts, and to make apparent the limits of the work on which the ACCC has relied. The statements contained in NERA's letter to you in no way alter that situation or undermine or modify any of the findings our Submission sets out.

Yours sincerely,

A handwritten signature in black ink, appearing to be 'JE' with a flourish.

Henry Ergas

Managing Director
27 August 2001

Phone 61 2 6253 5622
Fax 61 2 6253 5644