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Mr Alan Johnston
The National Access Inquiry
Productivity Commission
P O Box 80
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Dear Mr Johnston

International comparisons of rates of return

I am writing to set the record straight regarding the 18 July 2001 submission by Network Economics Consulting Group (NECG) commenting on NERA's recent paper for the Australian Competition and Consumer Commission (ACCC) comparing international rates of return set by energy regulators.

The NECG submission asserts that NERA's report contains "three key analytical failings", namely:

- it "misrepresents" UK regulatory decisions because of "selectivity and bias" in the sample of decisions that are examined;
- it omits any analysis of differences in country-specific risk; and
- it omits any detailed discussion of differences in the three regulatory regimes, the impact of which is to expose Australian utilities to greater risk than their counter-parts in the UK and US.

On each of these issues, the assertions put by NECG are at best misleading and, in some cases, plain wrong. I elaborate below.

(i) Selectivity and bias

The first sentence of the main body of our report makes it perfectly clear that our client[1] - the ACCC - asked us to survey "post tax rates of return for gas and electricity distribution businesses in North America and the United Kingdom." Focusing on energy network businesses had the important advantage of comparing like with like, by abstracting from important differences in the risk characteristics between one utility sector and another.

Of course, our report did cite two decisions from the UK water sector, but this was simply to illustrate the impact of the different approach to tax in that sector (which follows that adopted by most Australian energy regulators), as compared with UK energy decisions (which do not). The summary table in our report (table 4.4) from which our conclusions are drawn makes it quite clear that the average rates of return we compare across jurisdictions are limited to energy alone.

On this basis, our analysis found differences in the rate of return assumption adopted by energy regulators in Australia and the UK. To suggest (as NECG do at page 12) that the rate of return `gap' we identified in *energy* sector decisions can be reduced by adding rail, telecommunications and air traffic control decisions to the UK side of the sample is preposterous.

(ii) Omitted analysis of country specific risks

NECG's report focuses on two country specific risk issues: differences in the equity premium, and "unusually low" interest rates in the UK.

Our report acknowledges the first of these, by referencing the imperfect integration of world capital markets. Whilst this phenomenon will inevitably allow differences in the measured equity premium to be sustained over time, the analysis of relative country risk cited by NECG reveals a fundamental misunderstanding of the equity premium and its relationship to country risk. First, country specific risks (such as inflation, exchange rate and sovereign credit risk) are primarily captured by measures of the "risk free" rate not the equity premium. Second, the simplistic graph of *nominal* total equity returns by country at page 13 reveals absolutely nothing about the equity premium since it conflates the equity premium and the risk free rate.

NECG's analysis of recent yield curves for UK and US government bonds and the "artificially inflated demand" for UK gilts arising from recent pension fund legislation may be interesting for capital markets practitioners, but it has limited relevance for our analysis.

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[1] I note that NECG chooses neither to reveal its client nor the terms of reference it was asked to address.

NECG notes that these effects are both post 1998, yet it appears to have overlooked the fact that three of the five UK energy sector regulatory decisions we cite were taken in 1997.

(iii) Omitted differences in the three regulatory regimes

Differences in regulatory regimes are of course important to investors' perceptions of risk and our report cites a variety of potential differences. Across each jurisdiction, some of these differences are positive whilst others are negative. NECG focuses on one, and suggests that Australian regulators tend to favour an approach to asset valuation that allows for "substantial revisions" to the RAB over time, thereby exposing investors to greater risk.

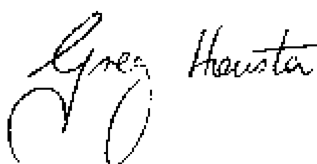
Whilst we would be the first to agree that reasonable assurance of cost recovery is fundamentally important for investors in long lived assets, in the case of the energy sector, the significantly greater risks NECG cites in Australia are more imagined that real.

Three cases from our survey of five Australian energy sector decisions were made under the gas code. In our view, the Australian gas code offers a relatively high degree of assurance that asset values will be consistent between one regulatory period and the next. In fact, had the UK's Transco been regulated under the Australian gas code for the past ten years it would certainly not presently be "embroiled in debates with [its] regulator on the appropriate value for the initial RAB". In drawing conclusions, NECG has overlooked the fact that Transco's regulatory asset value was first set almost a decade ago and has been infamously reviewed and revised on several subsequent occasions.

More generally, sections 3.1 and 4.2 of our report discuss a dozen different reasons why it is right to be cautious in using the results of our survey to make definitive statements about the impact of differences in energy sector rates of return on the relative incentives to invest in each jurisdiction. We note, however, that there is nothing to suggest these factors might all work `one way', and so they cannot reasonably be expected to alter the ranking arising from our survey.

In short, NECG's critique is based on a false premise and raises no new issues that are relevant for the matter we were asked to address. We stand by our analysis and the interpretations that have been draw from it.

Yours sincerely



Greg Houston
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