

11 February 2005



EDPR 2005-2010
Essential Services Commission of SA
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SUBMISSION TO THE DRAFT 2005 - 2010 ELECTRICITY DISTRIBUTION PRICE DETERMINATION

Envestra welcomes the opportunity to provide input to the Essential Services Commission of South Australia ('ESCOSA') Draft 2005 – 2010 Electricity Distribution Price Determination ('*Draft Determination*'). Envestra is providing comment specifically on the weighted average cost of capital contained in the *Draft Determination*.

It is well accepted that it is not possible to precisely estimate the cost of capital. There is a range of values for each of the CAPM and WACC components that can be considered reasonable. The real pre-tax weighted average cost of capital of 6.8% contained in the *Draft Determination* is unreasonably low due to the use of an equity beta of 0.8 and value of imputation credits (gamma) of 0.5. A comprehensive examination of these issues is included in the AGL Gas Networks response¹ to the Draft Decision for the NSW gas distribution network. Notwithstanding the differences between gas and electricity distribution networks the methods, data and parameter values used in that analysis make it relevant for consideration of the *Draft Determination*. The AGL Gas Networks response is located on the IPART website and can be accessed by using the link: <http://www.ipart.nsw.gov.au/whatsnew/latestreports.asp>. The key points from the AGL Gas Networks analysis are:

1. Monte Carlo simulation that uses reasonable assumptions about probability distributions for the WACC parameters finds that the appropriate real pre-tax WACC is between 7.8% - 7.9% at the 75-80% confidence levels.
2. The appropriate value of imputation credits (gamma) for use in determining the WACC is closer to zero than 0.5. This finding is consistent with the market based evidence and analysis Envestra provided to ESCOSA on 3 October 2003 as part of the consultation into the return on assets to be used in the Electricity Distribution Price Review².

¹ AGLGN Response to the Draft Decision On The Revised Access Arrangement For AGL Gas Networks, dated 7 February 2005

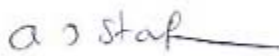
² ESCOSA, *Electricity Distribution Price Review: Return on Assets Discussion Paper*, August 2003

The methods used in the AGL Gas Networks response are robust and explicitly take account of the uncertainty surrounding the 'true' values for each of the WACC parameters. In our view this removes much of the subjectivity and arbitrariness surrounding these issues and provides a solid basis for regulatory decision-making. Given the evidence contained in the AGL Gas Networks response we would ask ESCOSA to reconsider the reasonableness and applicability of:

- The 6.8% real pre-tax WACC
- Equity beta of 0.8
- Value of imputation credits of 0.5

In our view the *Draft Determination* real pre-tax WACC of 6.8% is too low. To attract the necessary funds to invest in South Australian infrastructure the appropriate value for the real pre-tax WACC is close to 8%. Please call me on (08) 8227 1500 discuss any aspects of this submission.

Yours sincerely

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Andrew Staniford
Commercial Manager