Minutes

Meeting:	WACC in the Maximum Reserve Capacity Price – Stakeholder Workshop
Location:	IMO Board Room Level 17, Governor Stirling Building, 197 St Georges Terrace, Perth
Date:	1 November 2012
Time:	Commencing at 10:40am to 12:00pm

Attendees	
Allan Dawson	IMO (Chair)
Greg Ruthven	IMO
Suzanne Frame	IMO
Johan van Niekerk	IMO (Minutes)
Neetika Kapani	IMO
Brendan Clarke	System Management
Wana Yang	ERA
Duc Vo	ERA
Rajat Sarawat	ERA
Stefan Mero	ERA
Beauden Gellard	ERA
Neil Gibbney	Western Power
Noel Ryan	Western Power
John Rhodes	Synergy
Ky Cao	Perth Energy
Ben Tan	Tesla
Brad Huppatz	Verve Energy
Steve Gould	Eureka Electricity
Julian Widdup	Merredin Energy (telephone)
Pablo Campillos	EnerNOC

Item	Subject
1.	**WELCOME AND BACKGROUND** Mr Allan Dawson of the IMO welcomed the attendees. He explained that the workshop had been organised by the IMO to present the results of the review of Weighted Average Cost of Capital (WACC) used in the Maximum Reserve Capacity Price (MRCP). Mr Dawson explained that this review was undertaken as a result of submissions from a number of stakeholders that the capital structure assumptions that underpin the WACC calculation are not appropriate for the current composition of the WEM.

	Mr Dawson confirmed that PricewaterhouseCoopers (PwC) had been appointed to perform the review. He confirmed that PwC's report had been distributed by the IMO prior to the workshop. Mr Dawson confirmed that prior to appointing PwC, the IMO had consulted with stakeholders and banks in an effort to identify an alternative methodology for determining the cost of debt. He confirmed that during consultation with a number of banks, none was able to provide the IMO with a viable benchmark or index for determining the cost of debt. This was primarily due to financing deals being highly dependent on individual project characteristics. Mr Dawson outlined that stakeholders should recognise that the IMO is not a market leader in the area of WACC, that WACC was only used once annually by the IMO as part of the MRCP and that the IMO does not possess the same level of expertise in the area of WACC compared to regulators such as the Economic Regulation Authority (ERA), who review the WACC for regulatory decisions throughout the year. Consequently, the review had only considered accepted Australian regulatory practice as the appropriate basis for determining the WACC.
2.	**REVIEW OF REGULATORY PRACTICE: WACC USED IN THE MRCP** Mr Dawson invited Mr Greg Ruthven to provide additional detail on the review of regulatory practice. Mr Ruthven noted the recent history of falling Commonwealth Government bond yields and consequent fall in the risk free rate used in the WACC. He also noted that there has been a sustained shift in regulatory practice in relation to the value of gamma (franking credit value). As a result of these shifts, the IMO considered it appropriate to request advice from PwC on these matters. Mr Ruthven noted PwC's advice that Australian regulators continue to determine the risk free rate from recent observations of the yields of Commonwealth Government Securities. PwC had also advised that no challenge to this methodology had been brought to the Australian Competition Tribunal (ACT) in the period since early 2011 in which these yields have dropped to historic lows. On the cost of debt, Mr Ruthven noted PwC's advice that there was no Australian regulator that has determined a cost of debt estimate based on the cost of bank finance. It was also noted that the 'Bond-yield approach' as used by the ERA in the case of WA Gas Networks (WAGN) had recently been upheld by the ACT. It had been previously agreed by the MRCPWG that the 'Bond-yield approach' would be adopted within the WACC if it was upheld by the ACT. He confirmed that the ACT's decision in respect of WAGN was deemed by the IMO to signify regulatory acceptance. In relation to gamma, Mr Ruthven noted PwC's advice that the Australian Energy Regulator (AER) and ERA had consistently applied a value of 0.25 since a ruling by the ACT in 2011. Mr Ruthven confirmed that PwC had recommended in their report that the IMO should adopt a Gamma of 0.25. Mr Dawson asked the attendees if they had any comments. Mr Ky Cao thanked the IMO for performing the review. He suggested that whilst, in his opinion, the IMO's "hands are tied" when considering the options at their disposal for determining WACC, the use of the current methodology was best suited to regulated assets such as electricity networks rather than electricity generation assets. He suggested that there was a significant disconnect between the real costs faced by generation assets and the theoretical costs used in the MRCP.

Mr Cao suggested that since the inception of the market in 2006 there had been a significant decline in the attractiveness of the market for new investment. He suggested that it was unclear whether the market could support the development of new base-load capacity and that within two to three years there may be a capacity shortfall.

Mr Dawson thanked Mr Cao for his comments. Mr Dawson confirmed that the IMO had recognised the weakness in the current Reserve Capacity Price (RCP) methodology and noted that the proposed RCP formula being considered by the Reserve Capacity Mechanism Working Group (RCMWG) would see the current 15% discount removed.

Mr Cao questioned as to why the MRCP was not available as a regulated price for a 5-10 year period to provide a level of certainty to generators. Mr Dawson stated that the best avenue for generators to secure a long-term price arrangement was to contract bilaterally with a retailer. Mr Cao noted that retailers were less likely to enter into bilateral contracts for peaking capacity, and were more likely to target base-load and mid-merit capacity to meet their energy needs at the same time.

Ms Wana Yang suggested that since it was originally established to set a ceiling price in the case of an auction, the current MRCP was closer to a cost of capacity price and so if the intention was that the MRCP should represent a ceiling then the MRCP methodology should be revisited on that basis.

Dr Steve Gould asked what the IMO's recommendation was going forward. Mr Dawson confirmed that the ERA's 'Bond-yield approach' for determining the Debt Risk Premium (DRP) was being adopted in the MRCP for the 2015/16 Capacity Year. In addition, Mr Ruthven confirmed that the methodology for determining the risk free rate would remain unchanged while a revision of gamma from 0.5 to 0.25 would be proposed in a formal Procedure Change Proposal. It was confirmed that the change in Gamma from 0.5 to 0.25 was expected to result in a net increase in the MRCP of $4,000 to $5,000 per MW per year.

Mr Ben Tan enquired whether, given the recent and continuing volatility in equity markets worldwide, any consideration had been given to reviewing all components of the WACC including those normally reviewed only once every 5 years. Mr Ruthven confirmed that the review of all components had not been considered. The IMO only reviewed parameters where there a shift in markets or regulatory practice had been observed. He noted that it was still Australian regulatory practice to use the current methodology for determining the risk free rate, based on Commonwealth bond yields, and that the use of a market risk premium of 6% was still consistent with regulatory practice.

Mr Cao suggested that the generation business represented a higher risk than other regulated industries such as electricity networks. He indicated that the Commonwealth Bank had recently suggested that the costs of securing debt finance had increased significantly. Mr Dawson stated that the MRCP is based on an efficient investor with a credit rating of BBB and is not designed to incentivise the least credit-worthy investor. Mr Tan suggested that the owner of a single asset was unlikely to achieve a BBB rating. Mr Dawson stated that the MRCP methodology was not focused on individual entities but rather efficient investments and outcomes for the market.

Mr Duc Vo suggested that there were two issues with regards to the cost of debt produced by the WACC, being the methodology used and the underlying figures in the market. He identified that it was difficult to make changes to a methodology that took it away from recognised regulatory practice. He suggested that differences in credit rating and the cost of finance were taken into account by the ERA and other regulators, with network assets typically identified as A- and generation assets as

	BBB. Differences in risk are also captured by the asset beta and equity beta parameters within the WACC. He confirmed that he had discussed the issue of credit ratings on generation assets with ratings agencies and that they had indicated a rating of BBB to BBB+ was considered a good fit for efficient generation assets. Mr Cao expressed his agreement with Mr Vo. He suggested that the IMO needs to better recognise the difference between generation and network assets, with a view to better adjusting for specific risk related to generation including an adjustment in the level of Gamma from 0.5 to 0 to recognise that most of the money investing in generation assets in WA was likely to originate from outside of the country. Mr Ruthven confirmed that a full 5-yearly review of the WACC components had been performed previously by PwC in 2011. This had included a full consideration of the credit rating to be used in the methodology, recommended as BBB, as well as the asset beta and gearing ratio. Mr Tan suggested that beta was likely to fluctuate on a daily basis and so it should be re-assessed on an annual basis. Mr Vo outlined that the best proxy for assessing future levels of beta was to use a recent history, usually up to 5 years. Mr Tan suggested that this was impractical given the recent level of volatility in equity markets and the increased requirement for returns and increased margins on equity and debt recently observed. Mr Tan suggested that the current WACC parameters used a mixture of short-term and long-term assessments. Mr Dawson confirmed that the IMO understood the concerns of stakeholders and that the changes being implemented and, those being discussed by the RCMWG aimed to reduce volatility in the MRCP. Ms Yang confirmed that the ERA is required to approve that the MRCP Market Procedure had been followed correctly each year. In addition, Ms Yang confirmed that the ERA is required under the Market Rules to review the MRCP methodology once every 5 years. This was a separate process apart from any reviews to be undertaken by the IMO. Mr Vo stated that the ERA looked forward to receiving submissions from stakeholders on the ERA's review in due course. Mr Pablo Campillos questioned whether the IMO would consider whether a "significant economic event" had occurred, allowing a review of the 5-yearly WACC parameters under the Market Procedure. Mr Dawson confirmed that the IMO considered that there had not been any recent significant economic events to warrant any further review of the WACC. Mr Dawson confirmed that the IMO would assist the ERA with any queries during its review of the MRCP Procedure. Ms Yang confirmed that the review would be finalised before the end of October 2013.
3.	**REVIEW OF REGULATORY PRACTICE: WACC USED IN THE MRCP** Mr Ruthven confirmed that the IMO would proceed with the Procedure Change Proposal to amend the value of gamma to 0.25. He confirmed that the Draft Report for the 2015/16 MRCP would be based on the current Market Procedure (with a gamma value of 0.5), but would provide alternative values to stakeholders to show the outcome if the Procedure Change Proposal was accepted and gamma was amended to 0.25. Mr Dawson confirmed that the amendment of the procedure would follow the normal Procedure Change Process. Mr Dawson closed the meeting at 12pm, thanking all participants for their attendance.