Independent Panel questions to the AER

Dates of correspondence: 20-25 July 2018

Correspondence between: Natalia Southern (Chair of Panel), and Esmond Smith (Director – Rate of Return – AER)

*Please note the Panel's requests/comments are in **black** text and the AER's responses in **blue**.*

The Independent Panel (**Panel**) wrote to the AER regarding the following:

Question from Independent panel re interactions

- The Panel has been asked to assess the AER's draft guideline having regard to a number of factors including:

  " the interactions with other building block components and the relevant rules impacting estimation of those components."

- The AER's position paper further explains that the purpose of this factor is to:
- "make sure that any views from the panel are made in the context of the existing building block revenue framework and having reference to other relevant factors (for example, any methodologies defined in the binding PTRM/RFM methodologies)."[1]
- However, I have not found any reference in the July 2017 consultation paper to this factor, nor any specific comment in the submissions made in response to the consultation paper.
- In light of this, could you please provide an explanation and/or direct us to any documents that more clearly set out what your expectations are about the nature of interactions you are seeking for the Panel to consider.

AER response

- The AER has used the term 'interactions' in a general sense and interchangeably with the term 'interrelationships'.
- We touched on interrelationships between financial parameters in section 2.4.4 of the Draft rate of return Guideline Explanatory statement (Explanatory Statement). We are explicitly required to have regard to any interrelationships between estimates of financial parameters under the NER and NGR (for example see NER 6.5.2(e)(3)).
- While the question from the independent panel covered "other building block components", for completeness this note covers both interrelationships between rate of return input parameters and interrelationships with other building block components.

Interrelationships between rate of return parameters

- The rate of return parameters must be estimated to give an overall rate of return that will meet the allowed rate of return objective (ARORO) set out in the NER/ NGR and contribute to the achievement of the national electricity/gas objective (NEO/NGO). Regard for consistency is explicitly required for electricity distribution under NER

6.5.2(e)(3). There are equivalent provisions in the NER for transmission and in the NGR for gas distribution and gas transmission.

- The key interrelationships between financial parameters are:
    - Estimating the cost of equity (and in particular the equity beta) consistently with our assumed gearing ratio. We have done this via re-levering empirical beta estimates to a 60% debt to equity ratio and using these as the basis for our beta estimate of 0.6 (see Explanatory Statement p 251).
    - Estimating the cost of debt in a manner consistent with our assumed gearing ratio. Financial data from the firms we regulate supports a gearing ratio of 60% debt and we have consistent with this used observations on the credit rating and term of debt at issuance of the firms we regulate to inform the benchmark debt credit rating and term (see Explanatory Statement p 76).
    - Combining the cost of equity and cost of debt to calculate the Vanilla weighted average cost of capital (WACC) in a manner consistent with our parameter estimates. We have done this by using 40% equity and 60% debt when calculating the Vanilla WACC (see Explanatory Statement p 123).
    - There is also the need to be consistent with the way the return on equity is calculated and the value of imputation credits (or gamma is calculated) and that this is consistent with the application of the Post Tax Revenue Model. This is covered in the next section under interrelationships with other building block components.

Interrelationships with other building block components

- There are a number of interrelationships/interactions across building blocks. These include:

- Consistency between the allowed rate of return and gamma parameter estimates is required under the NER and NGR. See for example rule NER 6.5.2(d)(2):

> (d) Subject to paragraph (b), the *allowed rate of return* for a *regulatory year* must be:
>
> ….
>
> (2) determined on a nominal vanilla basis that is consistent with the estimate of the value of imputation credits referred to in clause 6.5.3.

- We have estimated the value of distributed imputation credits and the historically estimated MRP numbers consistently using a value for distributed imputation credits (or theta) of 0.6 (see Explanatory Statement p 215).

- Estimating the value of imputation credits consistent with the Post Tax Revenue Model (PTRM). We consider the Officer model underpins the post company tax PTRM (see page 396 of the Explanatory Statement) and have estimated the value of imputation credits on a post company tax basis (before investors incur personal taxes and personal costs). Our view here, consistent with our 'utilisation' approach to gamma, has been the subject of significant litigation and upheld as open to us by the Full Federal Court (see Explanatory Statement p 388).

- We use our imputation credit distribution rate to estimate the cost of raising equity funds. Under the Draft Guideline we would use a value of 0.83 for this purpose in estimating these opex costs (that are a small part of the opex allowance). This is not set out in the Explanatory Statement, but is set out the PTRM and one reason for quantifying a distribution rate consistent with our rounded gamma value of 0.5 and

our estimated utilisation rate (or theta value) of 0.6. (See for example p15 of our January 2015 final decision amending the Electricity distribution PTRM available here).

- We have considered the assumptions around cash flow timing in the PTRM in determining the appropriate compensation for debt raising fees (See Explanatory Statement pp 456-458).
- Another example of interrelationships we considered is the relationship between RAB multiples and outperformance under incentive schemes (such as the EBSS and CESS). A limitation of RAB multiples is the challenge in disaggregating where the multiple comes from. Table 13 gives a number of AER responses to submissions on financial performance measures that are driven by cash flows from multiple building blocks (see Explanatory Statement pp 155-160).