FINAL DECISION

Power and Water Corporation Distribution Determination 2019 to 2024

Attachment 3 Return on debt transition

April 2019

AUSTRALIAN ENERGY REGULATOR

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Note

This attachment forms part of the AER's final decision on the distribution determination that will apply to Power and Water Corporation for the 2019–2024 regulatory control period. It should be read with all other parts of the final decision.

The final decision includes the following attachments:

Overview

Attachment 1 – Annual revenue requirement

Attachment 2 – Regulatory asset base

Attachment 3 – Return on debt transition

Attachment 4 – Regulatory depreciation

Attachment 5 – Capital expenditure

Attachment 6 – Operating expenditure

Attachment 7 – Corporate income tax

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Attachment 15 – Alternative control services

Attachment 18 – Tariff structure statement

Attachment A – Negotiated framework

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Shortened forms

Shortened form	Extended form
ACG	Allen Consulting Group
AER	Australian Energy Regulator
bppa	basis points per annum
COAG EC	Council of Australian Governments – Energy Council
DRP	debt risk premium
ECA	Energy Consumers Australia
ERP	equity risk premium
MRP	market risk premium
NEL	national electricity law
NT NER or rules	National Electricity Rules As in force in the Northern Territory
NSP	network service provider
opex	operating expenditure
PIAC	Public Interest Advocacy Centre
PTRM	post-tax revenue model
PwC	PricewaterhouseCoopers
RAB	regulatory asset base
RBA	Reserve Bank of Australia
SL-CAPM	Sharpe-Lintner capital asset pricing model
WACC	weighted average cost of capital
ACG	Allen Consulting Group
AER	Australian Energy Regulator
bppa	basis points per annum
CCP13	Consumer Challenge Panel, sub-panel 13
ACG	Allen Consulting Group
AER	Australian Energy Regulator
bppa	basis points per annum
COAG EC	Council of Australian Governments – Energy Council
DRP	debt risk premium

3 Return on debt transition

In November 2018, the national electricity and gas laws were amended to require us to make a binding rate of return instrument. The binding instrument sets out the methodology for calculating the rate of return. The method must be capable of automatic application to all regulated network service providers without the exercise of discretion.

The first Rate of Return Instrument was published in December 2018 (the 2018 Instrument).[1] The 2018 Instrument specifies the return on debt as a formula based on a trailing average portfolio approach using third party debt data. It requires a business that is not already using a trailing average to transition to it over a 10 year period that is in the future.

Power and Water's revised rate of return proposal has adopted the draft 2018 rate of return guidelines and noted that we would apply the 2018 Instrument to its final decision.[2] However, it continued to disagree with the application of full debt transition.[3] As its revised proposal was submitted prior to the release of the 2018 Instrument, Power and Water also provided follow-up submissions in February 2019 which reiterated its position on debt transition.[4]

Power and Water submitted that a full transition (that is, a gradual transition to the trailing average on a prospective basis over the next ten years) was not appropriate. It proposed that its debt transition effectively started on 1 July 2009 due to the impact of the Ministerial Direction given in 2014.[5] Hence, it proposed an immediate transition to a

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1 AER, *Rate of return instrument*, December 2018, available at https://www.aer.gov.au/networks-pipelines/guidelines-schemes-models-reviews/rate-of-return-guideline-2018.

2 Power and Water's revised rate of return proposal adopted the draft 2018 rate of return guidelines for all aspects except for the return on debt transition, where it continued to disagree with the application of full debt transition. See: Power and Water, *Revised Regulatory Proposal 1 July 2019 to 30 June 2024*, 29 November 2018, pp. 49–50, 54.

3 Power and Water, *Revised regulatory proposal 1 July 2019 to 30 June 2024*, 29 November 2018, p. 49. This can be called either immediate transition or no transition as both aim to estimate a 10-year trailing average return on debt based on historical data without a transition period.

4 Power and Water, *Impact of rate of return binding instrument on revised proposal*, 21 February 2019, p. 1; Power and Water, *Chronology and outcomes of our customer and stakeholder engagement on rate of return*, 21 February 2019.

5 Power and Water, *Revised regulatory proposal 1 July 2019 to 30 June 2024*, 29 November 2018, p. 49; Power and Water, *Return on debt transition response to the AER's draft decision (public)*, 29 November 2018, pp. 3–4; Power and Water, *Regulatory Proposal 1 July 2019 to 30 June 2024, Attachment 01.10 – Return on debt transition, PUBLIC*, 31 January 2018; Power and water, *Attachment 10 return on debt transition*, 31 January 2018, p. 3; Power and Water, *Impact of rate of return binding instrument on revised proposal*, 21 February 2019, p. 1; Power and Water, *Chronology and outcomes of our customer and stakeholder engagement on rate of return*, 21 February 2019.

full trailing average from the start of the 2019–24 regulatory control period. This was reiterated in its follow-up submission in February 2019.[6]

We note Power and Water's case for an immediate transition was considered as part of making the 2018 Instrument and our draft decision for Power and Water. The instrument was a product of extensive consultation.[7] After considering the material Power and Water presented, as well as other relevant material from other stakeholders, we concluded that:

- A full transition should apply when transitioning to a trailing average return on debt for the first time.[8]
- The 2019–24 period would be the first time Power and Water is on a trailing average.[9]
- Full transition for Power and Water would prevent windfall gains or losses during transition.[10]

We consider the move to a 10-year trailing average should occur in a manner that prevents ex-ante windfall gain or loss to either the network business or consumers.[11] This is achieved by a full transition which aligns with application of the 2018 Instrument for the following reasons:

- an immediate transition would be backward looking and incorporate past estimates of the cost of debt. The ex-post selection of historical averaging periods can introduce bias into outcomes[12]
- an immediate transition would lead to windfall gains and losses.[13] In current circumstances, it would result in a materially higher return on debt than the full transition approach.[14]

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6 Power and Water, *Impact of rate of return binding instrument on revised proposal*, 21 February 2019, p. 1*;* Power and Water, *Impact of rate of return binding instrument on revised proposal*, 21 February 2019, p. 1; Power and Water, *Regulatory proposal 1 July 2019 to 30 June 2024, Attachment 01.10 – Return on debt transition, PUBLIC*, 31 January 2018.

7 All consultation stages are available on the AER website at https://www.aer.gov.au/networks-pipelines/guidelines-schemes-models-reviews/rate-of-return-guideline-2018.

8 AER, *Draft rate of return guidelines explanatory statement*, July 2018, pp. 332–337; AER, *Rate of return instrument explanatory statement*, December 2018, pp. 277, 280–284.

9 AER, *Draft rate of return guidelines explanatory statement*, July 2018, pp. 334–335; AER, *Rate of return instrument explanatory statement*, December 2018, pp. 280–284; AER, *Draft decision, Power and Water Corporation Distribution Determination 2019 to 2024, Attachment 3 Rate of return,* September 2018, pp. 16–17.

10 AER, *Draft rate of return guidelines explanatory statement*, July 2018, p. 335; AER, *Rate of return instrument explanatory statement*, December 2018, p. 283; AER, *Draft decision, Power and Water Corporation Distribution Determination 2019 to 2024, Attachment 3 Rate of return,* September 2018, p. 16.

11 AER, *Draft rate of return guidelines explanatory statement*, July 2018, pp. 332, 335.

12 AER, *Draft rate of return guidelines explanatory statement*, July 2018, pp. 332,335; AER, *Rate of return instrument explanatory statement*, December 2018, pp. 277, 282–283.

13 AER, *Draft rate of return guidelines explanatory statement*, July 2018, p. 335; AER, *Rate of return instrument explanatory statement*, December 2018, p. 283; AER, *Draft decision, Power and Water Corporation Distribution Determination 2019 to 2024, Attachment 3 Rate of return,* September 2018, p. 16.

In light of these earlier considerations, we have examined the most recent material submitted by Power and Water in its revised proposal and supplemental submission.[15] We find Power and Water's core conclusion—that it was already effectively on a trailing average approach—to be substantively similar to that previously put to us. Although no specific return on debt allowance was set under the Ministerial Direction applied to the 2014–19 period, Power and Water estimated an implied return on debt consistent with the Ministerial Direction (4.21 per cent).[16] This estimate was the basis for Power and Water's position that the trailing average approach was already 'effectively applied' in the current regulatory control period.[17] We note Power and Water's consumer engagement with its Customer Advisory Council (CAC).[18]

Our assessment of the available information does not lead us to the same conclusion as Power and Water. Prompted by the most recent Power and Water submissions, we further examined the available information on the Ministerial Direction:

- we had already noted that Power and Water's implied return on debt estimate assumed that the entire difference in revenue between the Ministerial Direction and the NT Utilities Commission's initial revenue determination was attributable to the return on debt.[19] There is no evidence to suggest that this is the case
- further, we now understand the Ministerial Direction was made by the then NT Treasurer in his capacity as 'Shareholding Minister' (i.e. the equity holder) and reflected 'a reduction in the return that the Territory expects to earn from its investment'.[20] To the extent the reduction is from the rate of return, this would imply a lower return on equity. We note total revenue under the Ministerial Direction was consistent with a return on debt set in line with the 2014 NT Utilities Commission decision (using an on-the-day approach) and a commensurately lower return on equity. This is evident in earlier correspondence from the NT Treasurer to Power and Water when discussing the proposed revenue reduction:[21]

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14 A higher return on debt means a windfall gain to the network business and corresponding windfall loss to consumers.

15 Power and Water, *Return on debt transition response to the AER's draft decision (public)*, 29 November 2018; Power and water, *Attachment 10 return on debt transition*, 31 January 2018; and Power and Water, *Impact of rate of return binding instrument on revised proposal*, 21 February 2019; Power and Water, *Chronology and outcomes of our customer and stakeholder engagement on rate of return*, 21 February 2019.

16 4.21 per cent in Power and Water's regulatory proposal and updated in its revised regulatory proposal.

17 Power and Water, *Return on debt transition response to the AER's draft decision (public)*, 29 November 2018, pp. 3–4; Power and water, *Attachment 10 return on debt transition*, 31 January 2018, p. 3.

18 Power and Water, *Chronology and outcomes of our customer and stakeholder engagement on rate of return*, 21 February 2019. We note that the material presented to the CAC stated that the Ministerial direction 'mandated the effective start of trailing average funding arrangement and customer prices in the current period'. We do not consider that this statement can be supported.

19 AER. *Rate of return instrument explanatory statement*, 17 December 2018, p. 283.

20 Treasurer David Tollner, *Letter re: Revised ministerial direction to Power and Water Corporation in relation to implementation of an alternative revenue path for the 2014-19 regulatory control period*, 19 June 2014, p. 1, available at http://hdl.handle.net/10070/274046.

21 Treasurer David Tollner, *Letter re: Ministerial direction to Power and Water Corporation in relation to implementation of an alternative revenue path for the 2014-19 regulatory control period*, 13 May 2014, p. 2, available at http://hdl.handle.net/10070/274032.

> The revenue path does not affect the revenue allowance for recovery of operating costs, repairs and maintenance, and a return of capital and should provide sufficient revenue to cover the Power and Water Corporation's debt obligations. However, it does not provide for a full return on equity.
>
> I am cognisant that the alternative revenue path is likely to result in the Power and Water Corporation not achieving a commercial rate of return and Government subsequently foregoing future dividend payments.

We also note that the 2018 Instrument specifies a 10 year transition from an on-the-day approach to a trailing average.[22] This means a firm must transition from an on-the-day approach to a trailing average approach over a 10 year period that is in the future. Power and Water agreed with this proposition in its response to our draft determination.[23]

Therefore, the relevant question is whether the 2019–24 regulatory period will be the first time Power and Water is on a trailing average cost of debt. The evidence indicates a first time application of a trailing average return:

- the NT Utilities Commission set an on-the-day return on debt in 2009, and this was the basis for revenues in the 2009–14 period[24]
- the NT Utilities Commission also set an on-the-day return on debt in 2014, and this was the legal basis for revenues in the 2014-19 period[25]
- the 2014 Ministerial Direction altered overall revenue recovery over 2014–19 but did not set out a separate return on debt allowance. We determined that this methodology was closer to an on-the-day approach[26]
- there was no annual debt update in either the 2009–14 or 2014–19 periods, and this is a necessary component of the trailing average approach[27]
- Power and Water's submission that at the end of 2018, the return on debt calculation from a 10 year trailing average approach would approximately equal the average recovered return on debt over 2009 to 2018 does not mean that a trailing average was being applied across that period.[28]

As 2019–24 will be the first time Power and Water is on a trailing average return on debt, we are bound to apply a full transition as per the 2018 Instrument.[29]

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22 AER, *Rate of return instrument*, December 2018, clause 9; AER, *Rate of return instrument explanatory statement*, December 2018, pp. 58, 276.

23 Power and Water, *Return on debt transition: response to the AER's draft decision*, 29 November 2018, p. 7.

24 NT Utilities Commission, *Final determination networks pricing: 2009 regulatory reset*, March 2009, p. 39.

25 NT Utilities Commission, *2014 Network price determination final determination, Part A*, April 2014, p. 125.

26 Treasurer David Tollner, *Letter re: Revised ministerial direction to Power and Water Corporation in relation to implementation of an alternative revenue path for the 2014-19 regulatory control period*, 19 June 2014; and AER, *Draft rate of return guidelines explanatory statement*, July 2018, p. 335.

27 AER, *Draft rate of return guidelines explanatory statement*, July 2018, p. 335.

28 Power and Water, *Return on debt transition: response to the AER's draft decision*, 29 November 2018, p. 8.

29 For example, see: NGL, Part 1, division 1A; NEL, Part 3, division 1B.

Our final decision is to commence a full 10-year transition to the trailing average in the first year of Power and Water's 2019–24 regulatory control period. This is consistent with our previous consideration of the material submitted by Power and Water in the explanatory statements for the 2018 rate of return review and our draft decision for Power and Water.[30]

[30] AER, *Draft rate of return guidelines explanatory statement*, July 2018, pp. 334–335; AER, *Rate of return instrument explanatory statement*, December 2018, pp. 280–284; AER, *Draft decision Power and Water Corporation Distribution Determinations 2019 to 2024 Attachment 3 Rate of return,* September 2018, pp. 16–17.