

Application by EnergyAustralia to re-open its 2004/05-2008/09 revenue cap

Decision

1. Introduction

1.1 On 27 April 2005 the Australian Competition and Consumer Commission (“ACCC”) set a revenue cap under the *National Electricity Code* (“the Code”) for EnergyAustralia for the regulatory control period 2004/05 to 2008/09. Pursuant to clause 13(1) of Schedule 2 to the *National Electricity (South Australia) Regulations* this revenue cap is deemed to have been set by the Australian Energy Regulator (“AER”) and may be revoked and substituted by the AER in accordance with the *National Electricity Rules* (“the Rules”). The AER has received an application from EnergyAustralia dated 11 May 2007 for the revocation and substitution of this revenue cap.

2. Relevant laws

2.1 On 16 November 2006 new rules for the regulation of electricity transmission networks (Chapter 6A) commenced operation. These replaced the rules formerly set out in Part B of Chapter 6. However, clause 11.6.2 of the Rules provides that Chapter 6, as in force immediately before the commencement of Chapter 6A, continues to apply to an existing revenue cap determination. This means EnergyAustralia’s application is governed by the former Part B of Chapter 6 of the Rules.

2.2 Under clauses 6.2.4(d) and 6.2.4(e) (as they then were) the AER may revoke and substitute a revenue cap for the remainder of a regulatory control period. These provisions relevantly state:

“(d) Notwithstanding clause 6.2.4(b), the AER may revoke a *revenue cap* determination during a *regulatory control period* only where it appears to the AER that:

- (1) the *revenue cap* was set on the basis of false or materially misleading information provided to the ACCC;
- (2) there was a material error in the setting of the *revenue cap* and the prior written consent of parties affected by any proposed subsequent re-opening of the *revenue cap* has been obtained by the AER;

...

(e) If the AER revokes a revenue cap determination under clause 6.2.4(d), then the AER may make a new revenue cap determination in substitution for the revoked revenue cap determination to apply for the remainder of the regulatory control period for which the revoked revenue cap determination was to apply.”

2.3 Clause 13(4) of Schedule 2 to the *National Electricity (South Australia) Regulations* provides that the question of whether a pre-existing revenue cap should be revoked, amended or varied is to be decided by the AER taking into account only matters that would have been relevant for that purpose under, or for the purposes of, the Code as in force immediately before the commencement date of the new *National Electricity Law* (ie. the Code as in force at 30 June 2005).

2.4 Under clause 6.2.4(d)(2), it is necessary to obtain the written consent of affected parties before a revenue cap can be revoked for material error. There is no such requirement with respect the revocation of a revenue cap under clause 6.2.4(d)(1).

3. History and background

(a) *EnergyAustralia's revenue cap*

- 3.1 The process of setting EnergyAustralia's revenue cap formally commenced on 23 September 2003 when EnergyAustralia lodged a submission setting out its proposed revenue cap for the regulatory control period 2004/05-2008/09.¹
- 3.2 EnergyAustralia proposed a debt margin of 147.5 basis points.² This was based on an estimated yield for a 10 year bond with a credit rating of BBB+, and consisted of a debt margin of 135 basis points, plus an additional 12.5 basis points to allow for debt raising costs.³ This proposal was based on data obtained from the CBASpectrum service. As at 1 September 2003, data from CBASpectrum would have produced a debt margin of 99 basis points. However, EnergyAustralia argued that debt margins were higher in preceding months. For the sake of consistency with its distribution business, EnergyAustralia proposed that the ACCC adopt the debt margin EnergyAustralia had proposed to IPART earlier in 2003, namely, 135 basis points. This figure was taken from EnergyAustralia's submission to IPART in April 2003, in which EnergyAustralia proposed a debt margin of 135 basis points, being the estimated yield on a 10 year bond with a credit rating of BBB+ produced by CBASpectrum as at 17 March 2003.⁴
- 3.3 In its draft decision dated April 2004, the ACCC used CBASpectrum to determine EnergyAustralia's debt margin, although it based this decision on a 10 year bond with a credit rating of A, rather than BBB+.⁵ Following the draft decision, EnergyAustralia made several submissions to the ACCC on the subject of its debt margin.⁶ EnergyAustralia argued that a credit rating of BBB+ should be used, but made no mention of the use of CBASpectrum.
- 3.4 In its final decision setting EnergyAustralia's revenue cap, the ACCC decided to continue to determine EnergyAustralia's debt margin by reference to a 10 year bond with a credit rating of A. The ACCC used CBASpectrum to estimate a yield on this type of bond of 90 basis points.⁷

¹ *EnergyAustralia's submission to Australian Competition and Consumer Commission, Transmission Revenue Determination 2004-2009* ("revenue cap proposal")

² The debt margin is added to a risk free rate to determine the cost of debt, which is a component of the WACC applicable to a TNSP.

³ Revenue cap proposal, attachment 11 (*NECG report on the Weighted Average Cost of Capital*), pages 27-31.

⁴ *EnergyAustralia's submission on the 2004 Distribution Revenue Determination*, 10 April 2003, Attachment 7 (*NECG submission on Weighted Average Cost of Capital for EnergyAustralia*), page 15.

⁵ *NSW and ACT transmission network revenue caps – EnergyAustralia: Draft Decision*, 28 April 2004, page 85.

⁶ *Response to ACCC's Draft Determination for EnergyAustralia's Revenue Cap 2004-2009*, 2 July 2004, pages 71-71 and Attachment 1 (*NECG Report*) pages 8-12; *EnergyAustralia's response to ACCC Supplementary Draft Decision for Revenue Cap (2004-2009)*, 24 March 2005, pages 25-26.

⁷ *NSW and ACT transmission network revenue cap; EnergyAustralia 2004-05 to 2008-09, Final Decision*, 27 April 2005, page 80.

(b) *TransGrid's revenue cap*

- 3.5 TransGrid's 2004/05-2008/09 revenue cap was set at the same time as EnergyAustralia's.⁸ Following the ACCC's draft decision,⁹ TransGrid made submissions to the ACCC in June, September and November 2004 relating to the data that should be used to forecast bond yields for the purposes of determining its debt margin. These submissions, which included a series of expert reports, argued that actual yields on long-term debt securities over 2003-04 were, on average, 17.7 basis points above the estimates produced by the CBA Spectrum database. On this basis TransGrid submitted that the ACCC should use the Bloomberg service to estimate yields since its estimates tended to be more consistent with observed yields on similarly rated bonds than those produced by CBASpectrum.
- 3.6 TransGrid requested that its submissions to the ACCC not be publicly disclosed. Because it could not seek public comment on these submissions, the ACCC advised TransGrid that it would not consider these submissions and did not take them into account in setting TransGrid's revenue cap. Nor did the ACCC take these submissions into account in setting EnergyAustralia's revenue cap.
- 3.7 In November 2006, TransGrid requested the revocation and substitution of its revenue cap on the basis that it was affected by a material error. On 7 February 2007, the AER decided that the failure to have regard to the submissions described above was a material error in setting TransGrid's revenue cap. The AER accepted that the debt margin should be set on the basis of estimates taken from the Bloomberg service. Having obtained the consent of affected parties, the AER revoked and substituted TransGrid's revenue cap under clause 6.2.4(d)(2) of the Rules. A copy of this decision can be found on the AER's web site (www.aer.gov.au).

4. Grounds for re-opening raised by EnergyAustralia

- 4.1 EnergyAustralia's request of 11 May 2007 identifies three grounds for the revocation and substitution of its revenue cap:
- (a) material error resulting from the use of CBASpectrum (clause 6.2.4(d)(2));
 - (b) material error resulting from the ACCC's process (clause 6.2.4(d)(2));
 - (c) revenue cap set on the basis of false or materially misleading information (clause 6.2.4(d)(1)).

(a) *Material error of law resulting from the use of CBASpectrum*

- 4.2 EnergyAustralia claims that the ACCC made what is described as a substantive error of law by using unadjusted CBASpectrum data. EnergyAustralia argues that the methodology used in the CBASpectrum service for estimating the 10 year debt margin has a systematic bias which produces results that are systematically significantly lower

⁸ TransGrid lodged its revenue cap proposal on 26 September 2003 (compared to 23 September 2003 for EnergyAustralia). The ACCC's draft and final decisions for TransGrid and EnergyAustralia were made on the same dates.

⁹ *NSW and ACT Transmission, Network Revenue Caps – TransGrid 2004/05-2008/09, Draft Decision*, 28 April 2004.

than the actual 10 year debt margin. The presence of a systematic bias in the data means that CBASpectrum does not estimate the current debt margin for 10 year debt, but instead estimates a figure which is, due to this methodological bias, a certain number of points below that margin.

- 4.3 The AER believes this could only be a material error if the ACCC had determined EnergyAustralia's debt margin in a manner that was not in conformity with the requirements of the Code.
- 4.4 In setting a revenue cap for EnergyAustralia, clause 6.2.4(c)(4) of the Code required the AER to have regard to EnergyAustralia's "weighted average cost of capital". This was defined in Chapter 10 of the Code as "[a]n amount determined in a manner consistent with schedule 6.1." The relevant provisions of Schedule 6.1 were:

"2.3 Cost of Debt

The cost of debt is estimated with reference to current prices in domestic and overseas corporate debt markets. Given the long lives of network assets, the cost of debt should reflect the cost of a long-dated debt portfolio.

...

4.2 Estimating the Cost of Debt

Typically, a network owner will have a portfolio of debt consisting of lines of debt with different maturities, durations and yields. Given the long life of transmission assets this debt portfolio would typically be long-dated. A weighted average cost of debt should be estimated, taking into account the maturity and duration characteristics of the portfolio and the associated current market yields. Market yields applicable to the debt should reflect fully the Network Owner's credit risk."

- 4.5 The Code gave the ACCC a broad discretion in relation to the manner in which it would establish EnergyAustralia's debt margin, requiring only that the methodology used by the ACCC was consistent with the objectives, principles, broad forms and mechanisms of the Code.¹⁰ These matters (in particular the relevant requirements of Schedule 6.1) are expressed in broad terms.
- 4.6 It follows that the ACCC did not make an error of law simply because there was another methodology that produced, or may have been more likely to produce, a better estimate of EnergyAustralia's debt margin. Assuming that the Code permitted more than one methodology to be used, the selection of that methodology was, in accordance with clause 6.2, a matter for the ACCC. The argument that there was a material error of law depends on whether the methodology used by the ACCC was one that it was permitted by the Code to employ, rather than the merits of the ACCC's decision.
- 4.7 The relevant provisions of Schedule 6.1 established several principles in relation to the cost of debt. One of these was that the cost of debt must be estimated with reference to current prices in domestic and overseas corporate debt markets and current market yields. The ACCC's task was to determine a benchmark yield on a hypothetical, 10 year, bond with a rating of BBB+. One approach to this task would be to identify and average the yields on existing bonds of that type. However, the scarcity of such bonds with a 10 year term calls into question whether this would be the most appropriate method for establishing this benchmark.

¹⁰ see clause 6.2.

4.8 The approach used by CBASpectrum is designed to overcome the scarcity of long dated bonds in the Australian market while also ensuring that the yield curve derived does not intersect yield curves of bonds with different credit ratings. An alternative approach which, for example, simply averaged the yields on existing bonds, might not necessarily produce a better estimate for the purposes of establishing a benchmark cost of debt, as it would be based on a small sample of actual bonds. Whether, in all the circumstances, it is appropriate to factor the scarcity of actual securities into the estimation of the yield on a 10 year, BBB+ bond, or how this should be done, are matters that go to the merits of the ACCC's decision.

4.9 However, in the AER's view, it is clear that CBASpectrum did produce an estimate of the yield on a hypothetical, 10 year, BBB+ bond, and that it did so by reference to current prices in corporate debt markets and current market yields. This is what was required by the Code. The fact that a better estimate might have been achievable by some other means does not mean that the Code forbade the use of CBASpectrum in establishing EnergyAustralia's debt margin.

(b) *Material error law resulting from the ACCC's process*

4.10 EnergyAustralia's request of 11 May 2007 repeats arguments set out in an earlier letter to the ACCC of 14 March 2007, namely, that:

- (a) the ACCC failed to have regard to a relevant consideration in setting EnergyAustralia's revenue cap;
- (b) the ACCC's decision was unreasonable;
- (c) the ACCC failed to afford EnergyAustralia procedural fairness.

4.11 The substance of these arguments is that the ACCC should have:

- (a) had regard to TransGrid's submissions in setting EnergyAustralia's revenue cap; or
- (b) alerted EnergyAustralia to this issue and given it an opportunity to be heard.

4.12 In relation to the first point, the AER (and the ACCC before it) typically sets a separate revenue cap for each TNSP. Submissions made in relation to one revenue cap are not necessarily relevant to another. If the regulator, in setting a revenue cap, was bound to have regard to every submission made in relation to each other revenue cap, the cumulative weight of these submissions would be overwhelming. However, the determination of the debt margin for TransGrid and EnergyAustralia was an exceptional case. The AER considers that the cost of debt for TransGrid and EnergyAustralia were both determined through a largely single process. There are several facts that support this conclusion. For example, this was a process to determine a benchmark debt margin for two state-owned TNSPs, in NSW, at a single point in time; TransGrid's submissions in relation to its cost of debt were published on the ACCC's web site in connection with both revenue cap decisions; a joint public forum was held with respect to both decisions; and there were various places in the EnergyAustralia decision on the rate of return where references were made to TransGrid submissions.¹¹ While not every issue relating to the TransGrid and EnergyAustralia revenue caps were common to both

¹¹ eg. paragraphs 4.5.3, 4.7.1,

decisions, the determination of the cost of debt for both TNSPs was, in reality, a task performed by the ACCC through a single process. This means that TransGrid's submissions relating to the use of CBASpectrum were relevant to the cost of debt for both TransGrid and EnergyAustralia. The ACCC's failure to have regard to these submissions was a material error in both decisions.

- 4.13 In relation to the second issue, the ACCC does not believe there was a denial of procedural fairness in setting EnergyAustralia's revenue cap, or that the ACCC's decision was unreasonable. EnergyAustralia is a well resourced commercial entity with a sound understanding of its regulatory environment. EnergyAustralia was given ample opportunity to be heard in relation to the determination of its debt margin. ACCC staff consulted with EnergyAustralia on a regular basis during both the preparation and consideration of its revenue cap application. EnergyAustralia was advised by experienced and eminently qualified economists. With the benefit of this advice, EnergyAustralia proposed to the ACCC (as it had previously proposed to IPART) a debt margin that was calculated using data from CBASpectrum. EnergyAustralia was aware, as a result of the ACCC's draft decision, that the ACCC intended to use CBASpectrum. In response to the ACCC's draft decision, EnergyAustralia (with the assistance of its advisers) questioned aspects the ACCC's draft decision on the debt margin, but did not question or resile from the use of CBASpectrum.

(c) Setting the revenue cap on the basis of false or materially misleading information

- 4.14 EnergyAustralia's letter of 11 May 2007 argues that, because of the use of data from CBASpectrum, EnergyAustralia's revenue cap was set on the basis of information that was false or materially misleading.
- 4.15 The AER does not consider that this ground has been made out. CBASpectrum produces estimated yields associated with hypothetical bonds. Observed yields over time may, by definition, differ from estimates established through extrapolation. However, while there are issues in relation to the methodology by which CBASpectrum produces yield curves for certain types of bonds, there is no basis to conclude that the estimates are false or misleading.

5. Revocation and substitution of EnergyAustralia's revenue cap

- 5.1 Having concluded that there was a material error in setting EnergyAustralia's revenue cap, the next question is whether the AER considers that it should be re-opened. The AER is of the view that rectification of this error involves the proper consideration of TransGrid's submissions. The issue is whether the proper consideration of TransGrid's submissions would have led to a different conclusion than the one reached by the ACCC in setting the revenue cap. This issue was discussed at length in the AER's decision of 7 February 2007 relating to TransGrid's revenue cap (at paragraphs 5.6 to 5.11). For the reasons set out in that decision, the AER considers that EnergyAustralia's revenue cap should be re-opened, and the debt margin set on the basis of estimates taken from the Bloomberg service.
- 5.2 The effect of this is to determine EnergyAustralia's cost of debt using a debt margin of 117.22 basis points, instead of the 90 basis points used in setting the revenue cap. This results in a cost of debt of 7.152%. The effect of this revocation and substitution is an increase in EnergyAustralia's MAR for each year of the regulatory control period. The

AER is also of the view that it is appropriate for EnergyAustralia to recover this shortfall over the final year of the regulatory control period in a manner that is NPV neutral. The AER has therefore decided to substitute a revenue cap in which the X-factor is increased from -5.40% to -11.29%.

- 5.3 The changes to EnergyAustralia's MAR that will result from this decision are as follows:

| Smoothed MAR (\$m) | 2004/05 | 2005/06 | 2006/07 | 2007/08 | 2008/09 | Total (Nominal) ¹² |
|----------------------|---------|---------|---------|---------|---------|-------------------------------|
| Original revenue cap | 91.27 | 98.59 | 106.50 | 115.05 | 124.28 | 535.68 |
| Amended revenue cap | 91.27 | 98.59 | 106.50 | 115.05 | 131.21 | 542.62 |

6. Consent of affected parties

- 6.1 EnergyAustralia identified two parties it considered to be potentially affected by the re-opening of its revenue cap, namely, Country Energy and TransGrid. EnergyAustralia has stated that these are the only parties with a direct commercial relationship with EnergyAustralia for the use of its transmission network, whose prices may be affected by the re-opening. While there are three other parties with a direct commercial relationship with EnergyAustralia for the use of its transmission network, EnergyAustralia has advised the AER that there will be no change to the charges payable by these parties as a result of this decision. Accordingly, the AER is satisfied that the only parties potentially affected by this decision are Country Energy and TransGrid.
- 6.2 On 15 November 2007, the AER wrote to Country Energy and TransGrid asking whether they consider themselves to be affected by the re-opening of this revenue cap and, if so, whether they consent to the re-opening. TransGrid replied on 28 November 2007, consenting to the re-opening. As no replied was received from Country Energy, the AER has concluded that it does not consider itself to be an affected party. Accordingly, the AER considers that the parties affected by the re-opening of EnergyAustralia's revenue cap have consented.

7. AER decision

- 7.1 The AER determines that, with effect from the date of this decision:
- pursuant to clause 6.2.4(d)(2) of the *National Electricity Rules*, the revenue cap set for EnergyAustralia by the ACCC on 27 April 2005 for the regulatory control period 2004/05 to 2008/09 is revoked;
 - pursuant to clause 6.2.4(e) of the *National Electricity Rules*, a new revenue cap is set for EnergyAustralia for the regulatory control period ending 30 June 2009, being the revenue cap set by the ACCC on 27 April 2005, varied so that, in determining the maximum allowed revenue for the year 2008/09, the X factor is increased from -5.40% to -11.29%.

¹² Total may not add due to rounding.

Dated: 21 December 2007