

12 December 2017

Mr Warwick Anderson
General Manager, Network Finance and Reporting
Australian Energy Regulator
GPO Box 3131
Canberra ACT 2601

Dear Mr Anderson,

RE: REVIEW OF RATE OF RETURN GUIDELINE – ISSUES PAPER

Thank you for the opportunity to contribute to the development of the Australian Energy Regulator's (AER) next rate of return guideline (the Guideline).

Overview

The AER's Issues Paper, published on 31 October 2017, covers a range of topics that will be closely monitored by customers, network businesses, investors along with economic regulators in other jurisdictions. Therefore, ATCO would like the AER to consider the following suggestions when finalising the Guideline:

- Regulatory certainty and stability are key drivers of investor confidence and therefore, also drive the ability of gas distribution businesses to provide valuable services to energy consumers over the long term.
- An increasingly competitive energy market, combined with existing cost allocation and ring-fencing requirements, are sufficient to ensure returns are commensurate with the inherent risks of gas distribution businesses.
- The significant rate of change in energy markets and customer preferences will require periodic review and enhancement of the Guideline, in conjunction with reviewing the ongoing effectiveness of the overarching form of economic regulation for gas distribution businesses.

About ATCO Australia

ATCO Australia is a customer-focussed company that develops, builds, owns and operates a range of energy infrastructure assets, supporting residential, business and commercial consumers across Australia. The Australian business includes:



- ATCO Gas Australia, which owns and maintains the largest gas distribution network in Western Australia, connecting over 750,000 customers through more than 14,000 km of natural gas pipelines and associated infrastructure. ATCO Gas Australia is subject to economic regulation by the Economic Regulation Authority under the National Gas Law (NGL) and National Gas Rules (NGR) as applied in Western Australia;
- ATCO Power Australia, which owns and operates two power generation facilities in Australia (a joint-owned facility in Adelaide and a wholly-owned facility in Karratha) with a combined capacity of 266 MW. ATCO Australia's Karratha facility supplies electricity to Horizon Power under a long-term power purchase agreement; and
- ATCO Structures and Logistics, which has been operating in the Australian marketplace since 1961. Today, ATCO Structures & Logistics has two manufacturing facilities and eight offices across the country delivering modular solutions to a diverse group of customers.

The ATCO Australia Group is part of the worldwide ATCO Group of companies with approximately 7,000 employees and assets of \$21 billion. ATCO is engaged in pipelines and liquids (natural gas transmission, distribution and infrastructure development, energy storage, and industrial water solutions); electricity (electricity generation, transmission, and distribution); retail energy; and structures and logistics.

Background

Following the West Australian State Election in March 2017, the new Government announced that the Economic Regulation Authority (ERA) will continue to regulate gas and electricity networks in Western Australia. The regulation of gas networks in Western Australia operates under the National Gas Law and National Gas Rules through an applied law scheme. Similar to the AER, the ERA is required to conduct a review of the Guidelines that apply to regulated gas networks and transmission pipelines in Western Australia.

The ERA announced on the 27 November 2017 that they will publish a draft Guideline in the first-half of 2018 to allow time to consider any relevant information provided by stakeholders in response to the AER's issues paper. The ERA intends to publish the final updated Guideline in the second-half of 2018.

ATCO Gas Australia (ATCO) is of the view that the next Guideline should build constructively and incrementally on past decisions and analysis, where justified, updating relevant empirical evidence and providing stakeholders with a clear understanding of how the AER (and ERA) reaches its conclusions. ATCO agrees with the position outlined in the



AER's Issues Paper that the Guideline process should not seek to 'reinvent the wheel' for setting the rate of return. As the Issues Paper has noted:

...we consider this review should seek to build on the current Guideline rather than start afresh. There are a number of aspects of the current approach that are reliant on market data and empirical analysis, and this material would clearly need to be updated. However, there are a number of aspects of the current approach that are driven by finance theory and available academic literature. We are not aware of any significant new developments in this area that might warrant us taking a new approach. (p.8)

Response to questions posed by the AER targeting specific input

ATCO's response to each of the questions raised in the Issues Paper is detailed below.

Question 1: In your view, to what extent has the current approach to setting the allowed rate of return achieved the National Electricity Objective (NEO) and National Gas Objective (NGO), the Allowed Rate of Return Objective (ARORO), and the related revenue and pricing principles (RPPs)?

Whilst it is not possible to show conclusively that the various objectives under the National Gas Rules that are relevant to the determination of the allowed rate of return have been achieved, the AER and stakeholders generally agreed in the 2013 Guideline process that the trailing average approach was an efficient approach that could contribute to the achievement of the Rate of Return Objective and the NGO. The AER has implemented the trailing average approach with a transition. In contrast, in Western Australia the ERA has implemented the hybrid trailing average approach without a transition, which ATCO proposed as part of its last regulatory process. Whilst this approach differs from the method detailed in the ERA's rate of return guideline, it has now been adopted in all subsequent decisions by the ERA. ATCO accepts that the hybrid trailing average method better meets the various objectives under the NGR as it mimics the debt raising practices commonly adopted by private networks.

The current approach for the cost of equity can result in a "lottery" effect, whereby the customers of two networks, whose revenues are reset just a few months apart, can receive materially different outcomes, depending on whether interest rates happen to be high or low at the time the AER makes each of those decisions. ATCO is of the view that the various



objectives under the NGR are best met by providing a more stable return on equity allowance over time.

Overall, ATCO supports an incremental approach to reviewing the guideline by both the AER and ERA in order to provide regulatory stability and to meet the various objectives under the NGR.

Question 2: Should information on profitability, asset sales, financeability and any other financial information be used when assessing outcomes against the NEO and NGO, ARORO, and the related RPPs? If so, how?

The central focus of the NGO, Rate of Return Objective and the Revenue and Pricing Principles is efficiency. ATCO believes that the AER must consider information that assists in promoting the efficient investment in and efficient operation and use of gas services when assessing the Guideline rather than information that has a short term focus.

When assessing outcomes against the NGO, Rate of Return Objective and the Revenue and Pricing Principles, ATCO further believes it is important to consider overall performance rather than specific components or input. Focusing on these individual components may give a distorted view of a network's position and approach to funding existing and future infrastructure needs and investments, particularly given the year-to-year performance can be influenced by many factors. For example, the method of smoothing revenue adopted by the regulator can influence short term profitability, however the role of the overall framework is to promote efficient outcomes.

The AER should explore the potential use of financeability assessments to ensure consistency of modelling outcomes with the assumptions in the rate of return. Financeability assessments are used routinely by a number of regulators in the UK (e.g. Ofgem and Ofwat) and some regulators in Australia (e.g. IPART and ESC) as a cross-check of their regulatory decisions. Evidence of a sustained deterioration in credit quality/financeability could result in networks being unable to refinance or raise new debt on reasonable terms. This, in turn, would undermine the business's ability to attract the capital required to make efficient investments. The solution to a financeability problem is not necessarily an increase in the allowed rate of return. Regulators in other jurisdictions have typically addressed financeability problems by re-profiling regulated cash flows from future periods. However, the identification of a financeability problem could also indicate that certain components of the network's revenue allowance have been set too low (i.e., if the cash flows generated are too low to comfortably meet the business's debt obligations).



Question 3: Is the current approach to setting the benchmark term and level of gearing appropriate?

ATCO considers that the 60 per cent gearing figure should be maintained unless there is evidence of a material change in the average gearing over the historical period. In assessing the historical period, ATCO considers that gearing should be estimated on a market value basis to be consistent with other weighted average cost of capital parameters that are estimated on a market value basis.

ATCO observes that recent rises in the share prices of listed energy infrastructure companies has resulted in prevailing estimates of the gearing falling. These recent observations of gearing reflect short term increases in equity prices. However, the AER should consider this in the context of: the historical period; and transaction costs associated with both issuing and retiring debt meaning that networks do not seek to maintain a constant gearing ratio over the short term.

Further, maintaining the current gearing ratio avoids the need to develop a transition mechanism to the new gearing ratio. A transition mechanism would be required due to the operation of the trailing average and the historical debt previously assumed.

Question 4: Should the conditions and process for setting averaging periods be refined?

ATCO supports the approach to setting the averaging period that reduces volatility and facilitates consistent outcomes.

The averaging period for the risk-free rate should be determined by considering the approach that is likely to produce the best estimate of the required return on equity taking into account the preference for overall stability in estimates of the return on equity.

ATCO notes the importance of allowing each regulated business to set its own averaging period. This enables the business to issue (or price) its debt in a way that reasonably matches the regulatory allowance for their individual business. Enabling such matching delivers benefits to consumers in that businesses would otherwise face more risk and a higher cost of debt. However, the conditions for the averaging period should consider the practical implications of the annual cost of debt update and the time required to prepare and approve the annual tariff variation.



Question 5: To what extent are changes required to the current approach of transitioning from an on-the-day rate to a trailing average?

ATCO's current rate of return is determined under the ERA's hybrid trailing average method and did not include a transition period from the on-the-day measure.

ATCO notes that the need for a transition is a point of difference between the AER and ERA. As part of ATCO's most recent Access Arrangement decision the ERA accepted that it is more appropriate to move directly to the hybrid trailing average approach, without any phasing in or transition:

*"1673. In doing so, the Authority recognises that there is no change required in hedging arrangements between the previous approach and the hybrid trailing average approach, as both involve a single estimate of the risk-free rate, set once at the start of the regulatory period. For the DRP, however, it is likely that the benchmark efficient firm would have adopted a portfolio of debt with a ten-year average term, and that the firm would have been reasonably recompensed over the past three access arrangements, without being excessively compensated. However, a transition on the DRP would likely introduce a shortfall 'under' for the regulated firm over the AA4 period, which could then not be recovered as the full transition to the trailing average DRP occurred in the AA5 period."*¹

ATCO encourages the AER to give due consideration to the ERA's reasoning for moving directly to the hybrid trailing average approach.

Question 6: Is it appropriate for us to review the return on debt implementation approach by performing a review of the four third party debt data series currently available to us? Please also explain if you think there is further value in broadening this scope of debt implementation issues and why you hold this view?

In Western Australia, the ERA adopts the bond yield approach to determine the debt risk premium rather than estimating it from a third party debt data series. The bond yield approach was developed by the ERA when there was a limited set of third party debt data series providers.

ATCO supports a review of the four third party debt data series that are currently available. The review should assess their suitability and consider whether there are any benefits

¹ Economic Regulation Authority, Final Decision on Proposed Revisions to the Access Arrangement for the Mid-West and South-West Gas Distribution Systems, 10 September 2015



compared to the bond yield approach. For example, the benefit of four independent data series is a reduction in the risk that the outcome will include any particular bias and sufficient depth if a debt series is no longer available for any reason.

Question 7: Would a more prescriptive approach to setting the equity risk premium be appropriate? If the Guideline has a more prescriptive approach to estimating equity risk premium, what set of conditions for reopening the Guideline would best achieve the national gas and electricity objectives and the allowed rate of return objective?

ATCO supports an approach to the estimation of the market risk premium and equity beta that results in regulatory stability and certainty in the cost of equity, rather than the individual components of the CAPM model.

In relation to the equity beta, ATCO notes that previous methods to estimate equity beta have varied substantially over time. IPART have recently found merit in using a Vasicek-adjusted beta to increase the stability of beta estimates through time. In its October 2017 draft decision on its WACC methods IPART stated:

Several studies have found equity betas obtained from ordinary least squares (OLS) regression analysis are likely to be subject to a high degree of estimation bias due to sampling error. Regulators commonly adjust for this bias using the Vasicek and Blume methods.

Our current practice is to make a judgement on the appropriate beta by considering the OLS beta with no adjustments, the Blume-adjusted beta and Vasicek-adjusted beta. We have decided to discontinue considering the Blume-adjusted beta because it is an automatic, formulaic and arbitrary adjustment. We consider that the Vasicek adjustment is preferable because it relies on firm-specific information to adjust the empirical results.²

In relation to the market risk premium, ATCO observes that the ERA noted that it is not reasonable to constrain the market risk premium to a fixed range:

“The random behaviour of the risk-free rate in Australia to date, and more particularly, its pronounced decline in the current economic environment, leads to a situation where the combination of a fixed range for the MRP and prevailing risk-free

² IPART, Draft decision | Review of our WACC method, 31 October 2017, pg 4-5



rate may not result in an outcome which is consistent with the achievement of the average market return on equity over the long run.”³

Furthermore, ATCO notes that the ERA has adopted a market risk premium estimate that includes reference to forward looking indicators of market conditions. Their most recent estimate of the market risk premium is 7.4 per cent in its June 2016 final determination for Dampier Bunbury Natural Gas Pipeline. The ERA arrived at this value after concluding that:

“481. The results indicated the market return on equity was stationary.

482. However, the results produced mixed evidence on the stationarity of the MRP, with the analysis supporting a conclusion that the MRP is non-stationary. This finding led the Authority to the important conclusion that its previous long run historical estimate of 6 per cent could be a poor predictor of the MRP prevailing in future regulatory periods. The Authority therefore dropped the fixed estimate of 6 per cent, instead establishing a range of possible future outcomes for the MRP, informed by information that a rational market participant would use in making investment decisions.”⁴

The AER should consider the approach adopted by other regulators in determining their approach to setting the market risk premium and equity beta that assists in achieving regulatory stability and certainty in the cost of equity.

Question 8: Is the theory underlying the Black CAPM still appropriate for informing an equity beta point estimate? In its place, should alternative information be used to guide the selection of an equity beta point estimate?

Financial theory has evolved considerably since the Sharpe Lintner CAPM was developed in the 1960s and it is widely accepted in the field of finance that the CAPM over (under) estimates the returns of low (high) beta stocks, as well as misprices value/growth and small/large stocks.

ATCO considers that the Black CAPM continues to remain appropriate to inform the equity beta estimate and suggest that the AER give due consideration to the ERA’s approach of

³ Economic Regulation Authority, Final Decision on Proposed Revisions to the Access Arrangement for the Dampier to Bunbury Natural Gas Pipeline 2016 – 2020, Appendix 4, 30 June 2016 DBP WACC decision, paras. 483

⁴ Economic Regulation Authority, Final Decision on Proposed Revisions to the Access Arrangement for the Dampier to Bunbury Natural Gas Pipeline 2016 – 2020, Appendix 4, 30 June 2016 DBP WACC decision, paras. 481-482



utilising information from the Black CAPM to establish the value of equity beta in the Sharpe Lintner CAPM.

Question 9: What is the appropriate role of dividend growth models (DGMs) in setting the allowed return on equity?

The dividend growth model evidence should be used as material evidence to inform the estimate of the market risk premium. ATCO considers that the AER should give due consideration to the ERA's use of the dividend growth model to estimate the upper bound of the market risk premium.

Question 10: Is it appropriate to limit the review of the valuation of imputation credits to updating the empirical analysis? Are there any particular issues we should take into account when updating empirical analysis?

ATCO considers that the AER should consider the composition of the empirical evidence that they use to update the valuation of imputation credits.

There should be consistency across the empirical evidence used to estimate the rate of return. For example, the market data used to estimate the equity beta should be consistent with the data used to estimate the valuation of imputation credits.

When updating the empirical analysis, the AER should consider the composition of the benchmark efficient entity when assessing the valuation of imputation credits. This will include consideration of the suitability of adopting the distribution rate of firms in the ASX 20 or the market as a whole as a proxy for the benchmark efficient entity. For example, the capital expenditure profile of the benchmark efficient entity, and the associated financing, may limit the ability of the firm to distribute credits to investors through franked dividends compared to many other listed business that have a different business model.

Question 11: Should expected inflation and its interaction with the allowed rate of return be a priority under the Guideline review?

ATCO supports the rate of return guideline review including the method to estimate expected inflation. The method of modelling revenue under the post-tax revenue model (current cost accounting) effectively leads to a real rate of return, of which the expected inflation is a driving factor. ATCO suggest that the AER give due consideration to the ERA's approach of

applying the bond breakeven estimates because we are of the view that market expectations provide the best estimates of expected inflation.

If you have any questions or would like to discuss any of these issues further, please contact Hugh Smith – Manager Regulatory Strategy, ATCO Gas Australia.

Sincerely,



Matthew Cronin
General Manager – Regulation