

**ATTACHMENT 1:  
IMPLICATIONS OF TRIBUNAL DECISIONS FOR ACTEWAGL DISTRIBUTION**

1. On 26 February 2016, the Tribunal handed down the Tribunal's Determinations which set aside the final distribution determinations made by the AER in April 2015 in respect of the NSW distributors and ActewAGL Distribution and the full access arrangement decision made by the AER in June 2015 in respect of JGN's 2015-20 access arrangement. The Tribunal remitted the matters to the AER to make the decisions again in accordance with the Tribunal's directions.
2. The Tribunal's Determinations consider matters that are relevant to the AER's impending Final Decision regarding ActewAGL Distribution under the National Gas Law (**NGL**) and National Gas Rules (**NGR**).
3. We indicated in our Revised AAP that, upon receipt of the Tribunal's Determinations, we would consider the implications of the Tribunal's Determinations for our proposal and, if necessary, make a submission to the AER on these. Subsequent to the Tribunal's Determinations being handed down, we sought to liaise with the AER to understand how the Tribunal's Determinations impacted on the making of the Final Decision. We were advised that the timing of the AER's Final Decision was dependent on the AER's decision with respect to whether to apply for judicial review of the Tribunal's Determinations. The AER filed the AER's JR Applications on 24 March 2016. On 1 April 2016, the AER confirmed by telecom that it intended to make the Final Decision by the end of May 2016. The AER has not provided any formal advice on its intention to consult with respect to the implications of the Tribunal's Determinations for the Final Decision.
4. Accordingly, we set out below our views on the implications of the Tribunal's Determinations for two aspects of the Final Decision:
  - 4.1 the return on debt (both transition and implementation); and
  - 4.2 the value of imputation credits (gamma).
5. The Tribunal's decision *Applications by Public Interest Advocacy Centre Ltd and Ausgrid* [2016] ACompT 1 (**Ausgrid Decision**) is the 'lead' decision in respect of the issues common to the NSW distributors, ActewAGL Distribution and JGN (together, **NSW/ACT Businesses**).<sup>1</sup> We therefore generally refer to the Ausgrid Decision below.
6. While we appreciate that the AER's JR Applications are on foot, the AER's JR Applications will not be heard and determined prior to the making of the Final Decision and we consider that, until the AER's JR Applications are so heard and determined, the AER's regulatory decisions, including the Final Decision, should be made consistently with the Tribunal's Determinations and the reasoning underpinning those Determinations.

**RETURN ON DEBT - TRANSITION**

7. In the Draft Decision, the AER applied the transitional arrangements for estimating the return on debt as outlined in its *Rate of Return Guideline* of

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<sup>1</sup> See, for example, *Application by ActewAGL Distribution* [2016] ACompT 4 at [4], [17]-[19].

December 2013 (**RoR Guideline**), using 2015/16 as the first year of the transition period. That is, the AER proposed:

- 7.1 for the 2015/16 year, to estimate the return on debt for that year for use in performing the true-up for the interval of delay by reference to the prevailing rate in the debt averaging period for that year (that is, to use the on-the-day approach to estimating the return on debt for that year); and
  - 7.2 to transition this return on debt to the trailing average approach over 10 years by updating 10 per cent of the return on debt each subsequent year to reflect prevailing rates in the debt averaging periods for each of those years.
8. As noted in our response to the Draft Decision of January 2016, it became clear to us from the detailed consideration of the return on debt in the merits review proceedings before the Tribunal in respect of the NSW/ACT Businesses that the method for transitioning to the trailing average approach to the return on debt in the AER's RoR Guideline will not deliver a return on debt estimate for ActewAGL Distribution that contributes to the achievement of the allowed rate of return objective in rule 87(3) of the NGR (**ARORO**). Rather, we consider that the NGR require the return on debt for ActewAGL Distribution to be estimated using the trailing average approach immediately, without any transition from the on-the-day approach.
9. In remitting the matters back to the AER, the Tribunal directed the AER to make the constituent decision on the return on debt in relation to the introduction of the trailing average approach in accordance with the Tribunal's reasons for decision.<sup>2</sup> The Tribunal's Determinations and reasoning support our proposed approach of immediately moving to estimating the return on debt using the trailing average approach. We set out the application of the Tribunal's reasoning as set out in the Ausgrid Decision to ActewAGL Distribution for the purposes of the Final Decision below. While we again acknowledge the AER's JR Applications, in the absence of decisions of the Full Federal Court that indicate the Tribunal's Determinations were in error, the Tribunal's Determinations should be applied for the purposes of the Final Decision.

### **Key findings of the Tribunal**

10. In making the Tribunal's Determinations, the Tribunal made the following key findings:
- 10.1 **The benchmark efficient entity (BEE) is an unregulated entity:** The Tribunal held that the AER erred in defining the BEE referred to in the ARORO as a regulated entity rather than an unregulated entity.<sup>3</sup> The Tribunal set out detailed reasons in support of its conclusions.<sup>4</sup>
  - 10.2 **It follows that the AER's approach to applying a transition must be reconsidered:** The Tribunal stated that once the step has been

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<sup>2</sup> See, for example, paragraph 1(b) of the directions accompanying the Ausgrid Decision.

<sup>3</sup> See, for example, Ausgrid Decision at [907], [914], [938].

<sup>4</sup> Ausgrid Decision at [891]-[922].

taken of starting with a BEE which has the characteristics of one hypothetical participant in the competitive market (rather than a regulated BEE), it follows that the AER's approach to transitioning the return on debt (under rule 87(11)(d) of the NGR, which is the equivalent provision to clause 6.5.2(k)(4) of the National Electricity Rules) must be reconsidered.<sup>5</sup>

10.3 **The correct approach under rule 87(11)(d) of the NGR is as follows:** The Tribunal's Determinations indicate that the correct approach under rule 87(11)(d) (which is the equivalent provision to clause 6.5.2(k)(4) of the National Electricity Rules) given a change in the methodology for estimating the return on debt is to:<sup>6</sup>

10.3.1 start with the efficient financing costs of the unregulated BEE;

10.3.2 consider whether the BEE would suffer any impacts as a result of the change in methodology and, if so, have regard to those impacts; and

10.3.3 consider whether the change in methodology would affect the actual entity (for instance, where the entity has entered into commitments such as hedge contracts in reliance on the previous methodology) and, only if the impacts on the actual entity are the result of efficient debt financing practices, have regard to those impacts. As discussed below at paragraphs 15 and 16, as ActewAGL Distribution has no issued debt, the change in methodology has no actual impact on ActewAGL Distribution and no consideration of the efficiency of ActewAGL Distribution's debt financing practices is required.

11. The Tribunal also noted the AER's findings, both in its RoR Guideline and the decisions under review, that the trailing average approach to estimating the return on debt is most likely to represent the proxy for the cost of debt for a supplier of the services in a competitive market.<sup>7</sup>

### **Application of key findings of the Tribunal to ActewAGL Distribution**

12. The Tribunal's Determinations suggest that, in making its Final Decision, the AER is required to estimate the return on debt (and the return on equity and overall allowed rate of return) by reference to an unregulated BEE. That is, rather than considering the debt financing practices of an entity under the on-the-day approach (as the AER did in its Draft Decision), the AER is required to consider the debt financing practices (and resulting costs) that would be adopted (and incurred) by an unregulated entity. Put another way, the AER is required to consider the debt financing practices (and resulting costs) that would be adopted in a workably competitive market for the provision of the relevant services.

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<sup>5</sup> Ausgrid Decision at [924], [927].

<sup>6</sup> Ausgrid Decision at [933]-[935].

<sup>7</sup> Ausgrid Decision at [915].

13. The debt financing practice that would be expected absent regulation is a staggered portfolio of fixed-rate debt. The trailing average approach provides an estimate of the return on debt that is commensurate with this practice. As noted by the Tribunal, this is accepted by the AER.
14. Given the trailing average is the best estimate of the cost of debt in a competitive market, there would be no impact on the BEE from changing the methodology for estimating the return on debt from the on-the-day approach to the trailing average approach.
15. Further, as ActewAGL Distribution has no issued debt, the change in methodology has no actual impact on ActewAGL Distribution. That is, there is no impact on ActewAGL Distribution that would warrant delaying the application of the trailing average approach to estimating the return on debt.
16. As outlined above, regard is to be had to actual impacts under the Tribunal's reasoning only to extent they result from efficient debt financing practices. We observe that any uncertainty as to precisely how the Tribunal contemplated the efficiency of an entity's debt financing practices is to be assessed would not affect the application of the Tribunal's reasoning to ActewAGL Distribution for the purposes of the Final Decision. This is because, with no issued debt, there is no impact on ActewAGL Distribution and no consideration of whether the debt financing practices of ActewAGL Distribution were efficient is required.
17. As a result, estimating the return on debt consistently with the Tribunal's Determinations requires the immediate adoption of the trailing average approach. As proposed in our Revised AAP, the trailing average approach to estimating the return on debt should be used both for the 2015/16 year for use in performing the true-up of the interval delay and for each regulatory year of the 2016-21 access arrangement period.
18. We note that it was not necessary for the Tribunal to have gone so far as to make the finding that the BEE is an unregulated entity to reach the conclusion that the NGR require the immediate adoption of the trailing average approach to estimating the return on debt. In particular, irrespective of whether the BEE is regulated or unregulated, the reference to 'efficient financing costs' in rule 87(3) of the NGR is a reference to the costs that would be incurred in a workably competitive market. Again, these costs are those that would be incurred if a staggered portfolio of fixed-rate debt is held and the trailing average approach provides an estimate of the return on debt that is commensurate with this practice. Much of the Tribunal's reasoning as to why the BEE is unregulated rather than regulated supports the proposition that, even if the BEE was regulated, the 'efficient financing costs' referred to in the ARORO are the costs that would be incurred in a workably competitive market.<sup>8</sup>

#### **Other comments of the Tribunal**

19. The Tribunal determined that the BEE referred to in the ARORO need not be one entity for the purposes of all regulatory decision-making in a particular regulatory period for all regulated service providers.<sup>9</sup> While this demonstrates error on the part of the AER in its Draft Decision (i.e. the AER was in error in assuming that

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<sup>8</sup> See Ausgrid Decision at [908], [914], [917]-[919], [920]-[921].

<sup>9</sup> See, for example, Ausgrid Decision at [904], [907], [916], [997].

100 per cent hedging was the only efficient response to the on-the-day approach to estimating the return on debt), the finding is of no consequence in circumstances where the Tribunal's Determinations specify an unregulated BEE. As noted above, it is uncontroversial that the trailing average is the best estimate of the cost of debt in a competitive market.

20. While the Tribunal describes various other matters that were suggested to have potential relevance to the AER's decision to apply transitional arrangements (without the Tribunal ruling on the issues raised),<sup>10</sup> we maintain that these matters do not permit the application of a transition to ActewAGL Distribution under the NGL and NGR. In particular:

20.1 Section 28(1)(b)(iii) of the NGL does not empower the AER to make adjustments to the allowed rate of return that would not otherwise be permitted under rule 87 of the NGR (including for a windfall gain or benefit to the business<sup>11</sup>). Rather, the provision governs the AER's exercise of discretion, where discretion exists. Section 28(1)(b)(iii) requires the AER, in exercising any discretion where there are two or more possible decisions that are likely to contribute to the NGO, to make the decision that is likely to contribute to the achievement of the NGO to the greatest degree. In circumstances where rule 87 of the NGR does not permit the AER to apply a transition to ActewAGL Distribution upon changing its methodology for estimating the return on debt from the on-the-day approach to the trailing average approach, a decision to make an adjustment for a windfall gain or benefit arising from this change in methodology would not be one of the 'possible' decisions to be considered for the purposes of that provision. Section 28(a)(b)(iii) therefore does not empower the AER to do so.

20.2 We maintain the views expressed in our Revised AAP as follows:

20.2.1 The regulatory regime established by the NGL and NGR does not permit the AER to make adjustments to the allowed return on debt for ActewAGL Distribution for a windfall gain or for consumers paying a second time for the spike in rates following the GFC, which adjustments would require an ex post review of previous regulatory allowances.

20.2.2 In any event, as the AER ultimately concedes itself, it cannot be ascertained with any certainty the extent to which there are accumulated windfall gains or losses from prior periods. The AER has not undertaken the exercise of seeking to determine, for ActewAGL Distribution, the difference between the allowed return on debt and the actual return on debt faced by the BEE in previous regulatory periods. It is possible that any perceived windfall gain or benefit in the prior period may have been

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<sup>10</sup> Ausgrid Decision at [939]-[942].

<sup>11</sup> The Tribunal refers (at [942]) to potential adjustments if consumers are 'paying a "second time" for the consequences of the spike in rates following the GFC'. This is the same issue that arises in considering whether there is a windfall gain. To the extent the Tribunal has considered this to be a separate issue, the Tribunal is in error.

balanced out by regulatory periods preceding the prior regulatory period and/or other features of the regulatory decision in respect of the prior regulatory period.

21. Further details of the arguments put by ActewAGL Distribution to the Tribunal on the above issues are set out in the following submissions (which are annexed to this submission for the AER's ease of reference):
  - 21.1 Ausgrid, ActewAGL, Endeavour Energy and Essential Energy joint submissions on allowed rate of return on debt of 20 August 2015; and
  - 21.2 Ausgrid, ActewAGL, Endeavour Energy and Essential Energy joint submissions in reply on return on debt of 17 September 2015.<sup>12</sup>
22. ActewAGL Distribution continues to press the views detailed in these submissions for the purposes of the Final Decision.

#### **RETURN ON DEBT - IMPLEMENTATION**

23. The Tribunal was not satisfied that the AER erred in adopting a simple average of the data published by the RBA and Bloomberg in estimating the return on debt.<sup>13</sup> While the Tribunal did not comment specifically on the curve selection methodology proposed by JGN, the Tribunal held that the AER's reasons for adopting the simple average of the RBA and Bloomberg curves were cogent and reasonable.<sup>14</sup>
24. ActewAGL Distribution maintains the position outlined in its Revised AAP that, in estimating the return on debt for 2016/17 and subsequent regulatory years, all available independent data sources and the average of these data sources should be tested to determine the data source and extrapolation method that best fits a representative sample of bond yields over the relevant averaging period. That is, ActewAGL Distribution maintains that the methodology for selecting the data source outlined in clauses 6.7 and 6.8 of its revised Access Arrangement should be applied.
25. However, in light of the Tribunal's Determinations and the AER's Draft Decision (which rejected our proposed approach), and given the costs associated with doing so, we have not yet applied the methodology for selecting the data source for our actual averaging period for estimating the prevailing rate and resulting return on debt for the 2016/17 regulatory year. If the AER is minded to accept our proposed data source selection methodology for the purposes of its Final Decision, we would be happy to undertake this exercise at that time.
26. In the event the AER maintains its position as outlined in the Draft Decision that an average of available data sources should be used for the purposes estimating the prevailing rate in the averaging periods for the 2016/17 regulatory year and beyond, we consider that the curve published by Reuters should also be included in the average. In particular, we observe the following:

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<sup>12</sup> There are a small number of documents referred to in those submissions which have not been provided to the AER by ActewAGL Distribution to date. Those reports are also annexed to this submission.

<sup>13</sup> Ausgrid Decision at [983].

<sup>14</sup> Ausgrid Decision at [984]; *Application by Jemena Gas Networks (NSW) Ltd* [2016] ACompT 5 at [46(5)], [47].

- 26.1 The 10 year Reuters estimates are only available on a daily basis since 25 May 2015,<sup>15</sup> and thus neither the AER's decisions regarding the NSW/ACT Businesses nor the Tribunal's Determinations consider the possibility of using this curve.
- 26.2 The analysis in the AER's Draft Decision, and the materials relied on by the AER in support of its Draft Decision, is limited to an assessment of the RBA and Bloomberg curves and does not consider the possible application of the Reuters curve.
- 26.3 In the Draft Decision (as in the decisions regarding the NSW/ACT Businesses under review in the Tribunal's Determinations), the AER adopted a simple average of the RBA and Bloomberg curves, in short, as it was not satisfied that either curve was clearly superior. The reasoning adopted by the AER in considering the RBA and Bloomberg curves is equally applicable to a consideration of the RBA, Bloomberg and Reuters curves.
- 26.4 Our expert, CEG advised that if a data source selection methodology is not adopted, some weight should be given to each of the RBA, Bloomberg and Reuters curves.<sup>16</sup> In particular, CEG concluded that Reuters' performance against CEG's criteria for assessing data sources was at least as good as Bloomberg's performance.
27. Given the above, in the event that the relevant data sources for estimating the prevailing return on debt in the averaging period for each regulatory year in the 2016-21 regulatory control period are determined 'up-front', a simple average of all three will result in a return on debt that contributes to the achievement of the ARORO to a greater degree than using an average of only the RBA and Bloomberg curves.

## VALUE OF IMPUTATION CREDITS

28. In making the Tribunal Determinations, the Tribunal decided that the value of 0.4 selected by the AER was too high and the AER's decision on gamma should be set aside.<sup>17</sup> The Tribunal directed the AER to make the constituent decision on gamma in accordance with its reasons for decision, including by reference to an estimated cost of corporate income tax based on a gamma of 0.25.<sup>18</sup>
29. While we proposed a value of imputation credits (or gamma) of 0.25, the AER adopted a value of 0.4 in its Draft Decision. The Tribunal's Determinations therefore support our proposed value of gamma.
30. The Tribunal did not accept the AER's approach that imputation credits are valued at their claimable amount or face value. Rather, the Tribunal considered their value is investors' determination of their worth, as reflected in observable market behaviour. The Tribunal further concluded that:

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<sup>15</sup> CEG, *Criteria for assessing fair value curves*, January 2016 (Appendix 5.04 to our Revised AAP) at [123].

<sup>16</sup> CEG, *Criteria for assessing fair value curves*, January 2016 (Appendix 5.04 to our Revised AAP) at [135].

<sup>17</sup> Ausgrid Decision at [1110]-[1111].

<sup>18</sup> See, for example, paragraph 1(c) of the directions accompanying the Ausgrid Decision.

- 30.1 Tax statistics can only provide an upper bound for the value of theta; they can only be used as a 'check'.<sup>19</sup>
- 30.2 The equity ownership approach overstates the redemption rate; even on the AER's own definition of theta, equity ownership rates are above the true maximum possible figure for theta. Like tax statistics, they can only be useful as a 'check' on other estimates.<sup>20</sup>
- 30.3 The equity ownership approach and tax statistics are inconsistent with a proper interpretation of the Officer framework underlying the Rules (because they make no attempt to assess value to shareholders and ignore factors that reduce value below face value).<sup>21</sup>
- 30.4 It follows that market studies must be used to estimate the value of imputation credits; market studies are consistent with the methods used to calculate the returns on equity and debt.<sup>22</sup>
- 30.5 The best estimate of theta is that derived by the updated study by SFG Consulting of 0.35.<sup>23</sup>
- 30.6 The AER erred in using a listed equity only measure of the distribution rate; it is appropriate to follow past practice (being all equity) at the present time (giving a rate of 0.7).<sup>24</sup>
31. Our response to the Draft Decision and Revised AAP is consistent with the Tribunal's Determinations. The Tribunal's Determinations suggest that, unless and until the Full Court sets aside the Tribunal's Determinations and an alternative decision is made, the only reasonably open course for the AER in respect of gamma in the Final Decision is to adopt our proposed value for gamma of 0.25.
32. For completeness, we note that we continue to hold the views put to the Tribunal by ActewAGL Distribution in respect of the value of imputation credits, which are set out in the following submissions (annexed to this submission for the AER's ease of reference):
- 32.1 Network applicants joint submissions on gamma of 20 August 2015; and
- 32.2 Network applicants joint submissions in reply on gamma (with updated references) of 21 September 2015.

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<sup>19</sup> Ausgrid Decision at [1048].

<sup>20</sup> Ausgrid Decision at [1093].

<sup>21</sup> Ausgrid Decision at [1095].

<sup>22</sup> Ausgrid Decision at [1074], [1096]-[1097].

<sup>23</sup> Ausgrid Decision at [1103].

<sup>24</sup> Ausgrid Decision at [1104]-[1106].