**Attachment 9-6: Response to AER Draft Decision on the Risk Free Rate & Averaging Period**

**9.1 Introduction**

In Envestra’s Access Arrangement proposal of September 2010, Envestra calculated the risk free rate as the annualised yield on ten year CGS over an indicative averaging period of 20 business days ending 2 July. The averaging period was indicative only and Envestra advised the AER that it proposed to provide the final averaging period as part of this revised regulatory proposal.[[1]](#footnote-1)

In the Draft Decision, the AER stated that under Rule 74 of the National Gas Rules, a proposed final averaging period must be submitted as part of the access arrangement proposal.

Rule 74 requires that a forecast or estimate must be arrived at on a reasonable basis and must represent the best forecast or estimate possible in the circumstances. There is no requirement that a final averaging period must be provided with the regulatory proposal in order to meet this criteria.

In any event the AER went on to note in the Draft Decision that it would accept a final averaging period that meets the averaging period design criteria[[2]](#footnote-2), namely:

1. The final averaging period should be nominated in advance of the commencement of the access arrangement period and should not include a date in the past;
2. The final averaging period should be between 10 and 40 business days in length.

In addition, the AER indicated it required the final averaging period to fall within the following boundaries:

1. That it be nominated by Envestra at the time of or no later than the lodgement of its revised regulatory proposal;
2. The final averaging period starts on a day that is after notification to the AER of the proposed period;
3. The final averaging period ends on or before Friday 29 April 2011;
4. The final averaging period is between 10 and 40 business days in length.[[3]](#footnote-3)

On 24 February 2011, Envestra advised the AER that it proposed to calculate the risk free rate over a period of 15 business days commencing 25 February 2011 and ending on 18 March 2011.[[4]](#footnote-4) Following that nomination, on 11 March 2011 unexpected and unprecedented events occurred in Japan and are continuing. The events in Japan have resulted in negative effects on global capital markets and an abnormally steep reduction in observed yields on the 10 year Australian Commonwealth Bonds (see graph below).



By email dated 16 March 2011, Envestra advised the AER that as a result of the recent events in Japan, it proposed to amend the averaging period nominated on 24 February 2011 to use the 10 day (rather than 15 day) averaging period between 25 February 2011 and ending on 10 March 2011.[[5]](#footnote-5) Envestra submits that this amended averaging period meets the criteria in the NGR and NGL and the AER’s design criteria and boundaries set out in the Draft Decision because:

* Using the 10 business days up to 10 March will avoid any bias in setting the risk free rate arising from the unexpected events in Japan. If an averaging period which includes the days immediately following the events in Japan is used, the resulting rate of return will not reflect prevailing conditions in the market for funds, given the aberrant and unexpected nature of the events.
* The amended 10 day averaging period meets the AER’s design criteria and boundaries in that:
  + This final averaging period was nominated before the submission of Envestra’s revised regulatory proposal and before commencement of the access arrangement period.
  + On 24 February 2011 Envestra nominated a 15 day averaging period commencing on 25 February 2011. That period did not include a date in the past. Envestra now only seeks to shorten that averaging period by 5 business days to reflect the unexpected events in Japan;
  + The amended averaging period is 10 business days in length.
  + The amended averaging period ends before 29 April 2011.
* There is no restriction in Rule 74 or 87 of the National Gas Rules or in the AER’s design criteria and boundaries listed in the Draft Decision that prevent Envestra from amending the averaging period as a result of these unprecedented and unexpected events. In fact, it is necessary to amend the final averaging period in light of the events on 11 March to ensure the risk free rate and resulting rate of return meet the requirements of those Rules.
* Given the recent events in Japan, Envestra’s amended averaging period ensures the rate of return reflects prevailingconditions in the market, not short term aberrations[[6]](#footnote-6).

Envestra also notes the decision of the Australian Competition Tribunal in *Application by Energy Australia and Others*[[7]](#footnote-7). In that decision, the Tribunal found that the AER exercised its discretion incorrectly or unreasonably in withholding agreement to the averaging periods proposed by the applicants because it did not have sufficient reason to believe that the proposed averaging periods were unlikely to produce an unbiased estimate of CGS rates in the regulatory control period.[[8]](#footnote-8)

The Tribunal observed that the only clear ground on which the AER might reasonably withhold agreement to an averaging period is that the period proposed would be likely to generate a rate of return that was inappropriate, ie too high or too low, having regard to the period to which it was to be applied.[[9]](#footnote-9) Envestra observes that applying the 15 day averaging period nominated by Envestra on 24 February 2011, in light of the recent and unexpected events in Japan, would result in an inappropriate rate of return that does not meet the requirements of Rule 87.

In finding error by the AER in *Energy Australia* the Tribunal noted that it “considers that an averaging period during which interests rates were at historically low levels is unlikely to produce a rate of return appropriate for the regulatory period”.[[10]](#footnote-10)

Similarly, using an averaging period which covers the period immediately post the events in Japan will not reflect a rate of return appropriate for the regulatory period applicable to Envestra.

The Tribunal also implied in the following passage that particular averaging periods that were considered “aberrant” might justifiably be rejected by the AER; “*However the Tribunal does not consider it appropriate to try to fine tune the averaging period so that it produces a risk free rate most likely to prevail during the regulatory period. It is one thing to reject a particular period as aberrant. It is quite another to seek an averaging period that produces what is thought to be the best result. The rules do not provide for the specification of a particular risk free rate…*”[[11]](#footnote-11)

Envestra submits that the AER should accept Envestra’s revised 10 day averaging period from 25 February 2011 to 10 March 2011, being a period that meets the requirements of NGR and NGL and the AER’s design criteria and boundaries set out in the Draft Decision. Therefore, the risk free rate to be used in Envestra’s in the Final Decision is 5.60%[[12]](#footnote-12).

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| **Date** | **Risk free Rate**  **(10 Year CGS annualised yield)** |
| 25-February-2011 | 5.60% |
| 28-February-2011 | 5.56% |
| 01-March-2011 | 5.59% |
| 02-March-2011 | 5.55% |
| 03-March-2011 | 5.60% |
| 04-March-2011 | 5.65% |
| 07-March-2011 | 5.59% |
| 08-March-2011 | 5.62% |
| 09-March-2011 | 5.63% |
| 10-March-2011 | 5.57% |
| **10 Day Average** | **5.60%** |

1. Draft Decision (SA), page 96. [↑](#footnote-ref-1)
2. Draft Decision (SA) p96. [↑](#footnote-ref-2)
3. Draft Decision (SA) p.96-97. [↑](#footnote-ref-3)
4. Letter from Mr Andrew Staniford, Envestra, to Mr Warrick Anderson, AER, dated 24 February 2011. [↑](#footnote-ref-4)
5. Email from C de Laine, Envestra, to A Peterson, AER, 16 March 2011 at 6:30pm [↑](#footnote-ref-5)
6. Refer to Envestra’s confidential submission [↑](#footnote-ref-6)
7. [2009] ACompT 8 [↑](#footnote-ref-7)
8. Paragraph 105 to 107. [↑](#footnote-ref-8)
9. Paragraph 93. [↑](#footnote-ref-9)
10. Paragraph 114. [↑](#footnote-ref-10)
11. Paragraph 115 [↑](#footnote-ref-11)
12. Using the full 15 day period would have reduced the proposed risk free rate by 4 bp. However, as Envestra nominated the 10 day period on 16 March the 10 day average should prevail. [↑](#footnote-ref-12)