Submission

Overall rate of return

September 2021

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Dear Mr Anderson

Ausgrid welcomes the opportunity to provide this submission to the AER's working paper on the overall rate of return. The rate of return instrument is one of the most significant decisions made by the AER in terms of its effect on both outcomes for customers and the financial stability of network businesses.

As highlighted in other industry and investor submissions, returns have been severely constrained since the 2018 rate of return instrument. It is critical that the rate of return is set a level that is robust to all economic circumstances and allows networks to support the energy market's transformation, promote efficient investment and provide customers with desired outcomes.

Our key recommendation is to undertake financeability testing as part of setting the overall rate of return process. We believe this is good regulatory practice and can be implemented in a transparent way.

We look forward to continuing engagement with the AER and other stakeholders as we move towards the next phase of the rate of return review process in 2022. If you would like to discuss our submission in more detail, please contact Fiona McAnally on [redacted] or [redacted].

Yours sincerely

[redacted]

Rob Amphlett Lewis
Chief Customer Officer

Introduction

The rate of return instrument is one of the most significant decisions made by the AER in terms of its effect on both outcomes for customers and the financial stability of network businesses. The consequences of setting the rate of return too high or too low can have significant effects on both.

The Rate of Return Instrument 2022 (RORI) is occurring when we are at a critical juncture in the transformation of the energy sector, with changes in the NEM over the next 5 to 10 years likely to have long term impacts for customers. For example, over the coming years there is an emerging need to invest in the capabilities required to efficiently integrate distributed energy resources (DER). Investing in reliability, resilience and the capability to flexibly respond to extreme weather risks is also an emerging need for networks, as global mean temperatures continue to rise.

We appreciate the AER summarising its position on the issues covered in the working papers so far. This allows stakeholders to clearly see where their views align and differ. Pleasingly, we have found there is alignment on most issues with only a few differences, which are described in this submission and our submissions to the Debt and Equity Omnibus draft working papers. Ausgrid also supports the ENA submission, which provides more technical detail on some matters.

Assessment Criteria

The AER proposes two new criteria it will have regard to when assessing methodological changes when setting the allowed rate of return:

- the materiality of the proposed change; and
- the longevity or sustainability of new arrangements.[1]

These appear to be reasonable, but we have some concern with the lack of explanation about how the materiality criterion will be applied. For example, it is unclear whether materiality means that if the change resulted in an immaterial impact to the result, the change would not be made because it is immaterial, or whether the change resulted in a material impact it would not be made because the change is considered too much. It would be helpful if the AER could provide some clarification on this matter in the final working paper. We suggest that the former is the most appropriate interpretation, because if a change were not made because it had a material impact on the outcome, despite compelling evidence, it would mean that rates of return would not be an unbiased efficient estimate, which is not in the long term interests of consumers.

Gearing

Gearing ratio

The AER observes that based on the methodology adopted in the 2018 RORI, gearing levels have reduced to be more like 55%, down from 60%, and that it is considering reducing the benchmark gearing to that lower level. [2] This is based on market values of gearing.

Ausgrid agrees that market values of gearing are the most appropriate to use for this purpose. The WACC, and the other parameters used in estimating the WACC, are market constructs so it makes sense for gearing to be estimated in the same way. However, a longer-term average should be used because market gearing values are sensitive to fluctuations in stock prices that do not necessarily reflect underlying changes in capital structure. Averaging over a longer period smooths out the “noise” and

[1] AER, Overall rate of return draft working paper, July 2021, p 22.
[2] AER, Overall rate of return draft working paper, July 2021, p 33.

would therefore be more representative of the underlying gearing. On this basis, the 10-year averages collected by the AER should form the basis of calculating gearing.

Ausgrid notes that the AER has received advice from Partington and Satchell that small movements (such as gearing reducing by 5 percentage points) have little effect on the cost of capital.[3] This may come into consideration when deciding whether to update gearing.

Subordinated debt

The working paper raises the question of subordinated debt, or hybrid securities, and whether this type of debt should be included in the calculation of gearing. There was inconsistency in the 2018 RORI in the treatment of subordinated debt.

Ausgrid's view is that subordinated debt is, for all intents and purposes, a debt instrument and should not be excluded from the calculation of gearing. While credit rating agencies may treat some proportion of this debt as equity for the purpose of calculating credit metrics, this is not the relevant test for whether an instrument is debt. The test should be the economic characteristics of the instrument, for example a mechanistically determined series of payments and ranking ahead of equity.

The main reason for raising such debt is to manage the credit rating. This means that the rating of the rest of the debt portfolio is reliant on the subordinated debt as part of the whole debt and credit rating management strategy. This debt is also generally independent of equity as it is raised with third parties rather than being a shareholder instrument. If the subordinated debt is excluded, all other debt of those businesses should be excluded.

The AER has noted that the treatment of these debt instruments can differ between the gearing calculation and the EICSI.[4] Ausgrid disagrees with this statement and submits that debt should be treated consistently across all parameters. Gearing affects re-levered equity betas, therefore to include one form of debt in estimating the risk of the firm but to exclude the cost of that debt in estimating the allowed debt costs creates an internal inconsistency in the allowed rate of return estimate.

Gamma

The AER proposes to continue using the 2018 methodology for calculating the value of imputation credits, known as gamma. That methodology is the utilisation approach which requires estimation of two parameters, the payout ratio and the utilisation rate. For the 2022 RORI, it is suggested that Australian Tax Office (ATO) data is considered in calculating the utilisation rate. ATO data was not used in the 2018 RORI because data was received from the ATO too late in the process to be properly consulted on and considered. We support the ATO data being given some weight because the ATO is the only organisation that holds actual data on how companies use imputation credits. Using data based on actual practice would contribute to determining the best possible estimate of gamma.

Ausgrid further supports the continued assumption that non-resident investors derive no value from imputation credits. This aligns with the utilisation methodology which is based on imputation credits redeemed by companies, and as foreign companies cannot redeem those credits under Australian tax laws they can have no value under the utilisation methodology. The lack of available data regarding value of imputation credits to non-resident investors is also a key constraint which limits being able to make a reasonable estimate that aligns with the assessment criteria.

[3] Partington and Satchell, Report to the AER: WACC and leverage, 19 May 2021, p 27.
[4] AER, Overall rate of return draft working paper, July 2021, p38.

Cross checks and financeability

Historic profitability and RAB multiples

The AER suggests that if cross checks are given a greater role in the 2022 RORI, historic profitability and RAB multiples should be included[5]. Ausgrid does not think either of these cross checks should play any significant role in cross checks for the RORI. As noted by the AER, profitability is inherently backward-looking and disaggregation of data, if it can be done reliably, does not tell us anything about required returns.[6] It is therefore not possible to infer from historic profitability the adequacy or otherwise of a rate of return that will apply in the future.

RAB multiples are forward looking because they incorporate an estimate of expected future returns. However, agreement about what constitutes a "reasonable" RAB multiple, or one that demonstrates that a business is only just earning an appropriate return, is non-existent. The first issue with RAB multiples is the assumption that a multiple over 1 implies abnormal returns. This does not take account of the widely accepted premise that the whole is greater than the sum of its parts. As noted by Coase firms add value by virtue of avoiding transaction costs.[7] This and building up expertise and knowledge to become more efficient means firms always worth more than the value of assets

The second issue is the extent to which RAB multiples are affected by unregulated parts of the business. While in some cases the unregulated business may currently be a small part of the transacted company, the growth assumptions for that smaller part of the business will materially alter the transaction value relative to the regulated RAB. Most networks are actively pursuing growth in various unregulated components of the market. RAB multiples are therefore of little value as a cross check to determine whether previous rates of return have under or over compensated firms.

Investment trends

The AER notes that it is difficult to use investment trends in a deterministic way because a number of other factors may influence investment expenditure.[8] We consider there is still merit investigating how RORI may have affected investment trends. It is important to ensure that any analysis disaggregates the capex expenditure into discretionary and non-discretionary. There are requirements on network businesses to maintain safety and reliability, and therefore responses such as reduced investment may be difficult to observe.

Financeability

The AER has indicated that it is open to exploring financeability tests as an overall cross check for rate of return.[9] It also noted that to date submissions advocating use of financeability checks had not engaged with the issues raised by the AER on how to implement financeability metrics for the RORI process. We understand that due to the timing of this draft working paper the AER did not have time to engage with industry submissions (in particular ENA) to the *Rate of return and cashflows in a low interest rate environment* draft working paper, which attempted to respond to those issues and present a way forward.

The main points made by Ausgrid in our previous submission were:

- we do not propose that financeability be used to back-solve a rate of return or be used to set any parameters (i.e. be used deterministically)

[5] AER, Overall rate of return draft working paper, July 2021, p52.
[6] AER, Overall rate of return draft working paper, July 2021, p51.
[7] https://www.nobelprize.org/prizes/economic-sciences/1991/press-release/
[8] AER, Overall rate of return draft working paper, July 2021, p 53.
[9] AER, Overall rate of return draft working paper, July 2021, p 57.

- financeability metrics would serve as a cross-check for internal consistency of the RORI, which was recognised as its purpose by the Regulatory Economics Unit:

  If the test is applied to a benchmark entity its results can be interpreted as a cross-check for overall consistency of the benchmark parameters.[10]

- if a business cannot operate under the benchmark RORI assumptions, it must draw on other resources that are not compensated for within the regulatory framework;
- it is unclear for how long a business should be expected to maintain a sub-optimal capital structure to manage its credit rating; and
- a proper application of financeability testing would include all metrics used by rating agencies when conducting their assessments, not only FFO/Debt.

One of the reasons put forward against financeability testing is that it is subjective and therefore requires judgement, which risks the transparency and predictability of the RORI.[11] Ausgrid's notes that an assessment of whether financeability metrics meet the thresholds specified by credit rating agencies is an objective activity and one that is measurable readily through published rating agency literature. Regulatory judgement is used throughout the RORI, which is one of the key reasons why cross checks, such as financeability testing, are required.

It has also been argued that there is no evidence of any financeability issues, so there is no need for financeability testing.[12] While we may disagree on that point, Ausgrid does not believe that there being evidence of financeability issues is a pre-condition to introducing financeability testing into the process. This would somewhat defeat the purpose of financeability testing being an early warning tool to avoid financeability issues in future. If financeability tests are implemented and do not indicate any issues, that seems to be a good regulatory outcome. If it does uncover an issue that may be remedied before causing industry disruption, that is also a good regulatory outcome – a win-win situation. This protects the long term interests of customers by ensuring long term financial stability of the network businesses.

Implementation

The AER has been provided with a version of the PTRM that contains relevant metrics, which could be built into the standard PTRM.[13] The AER would assess all metrics and determine whether the quantitative score aligns with the levels generally used for the credit rating of the benchmark efficient entity. We recognise that rating agencies use judgement and wider knowledge of the longer-term outlook for and management of companies when giving ratings. However, it is possible for the AER to make a reasonable assessment as evidenced by implementation of financeability testing by other regulators, including Ofgem and IPART.

If it is evident that the RORI would produce metrics inconsistent with the benchmark credit rating, the AER would revisit elements of the rate of return where it has used judgement and amend such the metrics are consistent.

Scenario testing

Ausgrid supports the use of scenario testing so that it is evident to all stakeholders how change to RORI components will impact future returns. While scenario testing should be used in combination with financeability metrics, it should not be limited to the financeability tests.

[10] AER, Rate of return and cashflows in a low interest rate environment | Draft working paper, May 2021, Appendix B, p 62.
[11] AER, Overall rate of return draft working paper, July 2021, p 57.
[12] CRG, Submission to AER review of inflation, 29 July 2020, p 18.
[13] These were submissions made in the recent Victorian regulatory decision process.

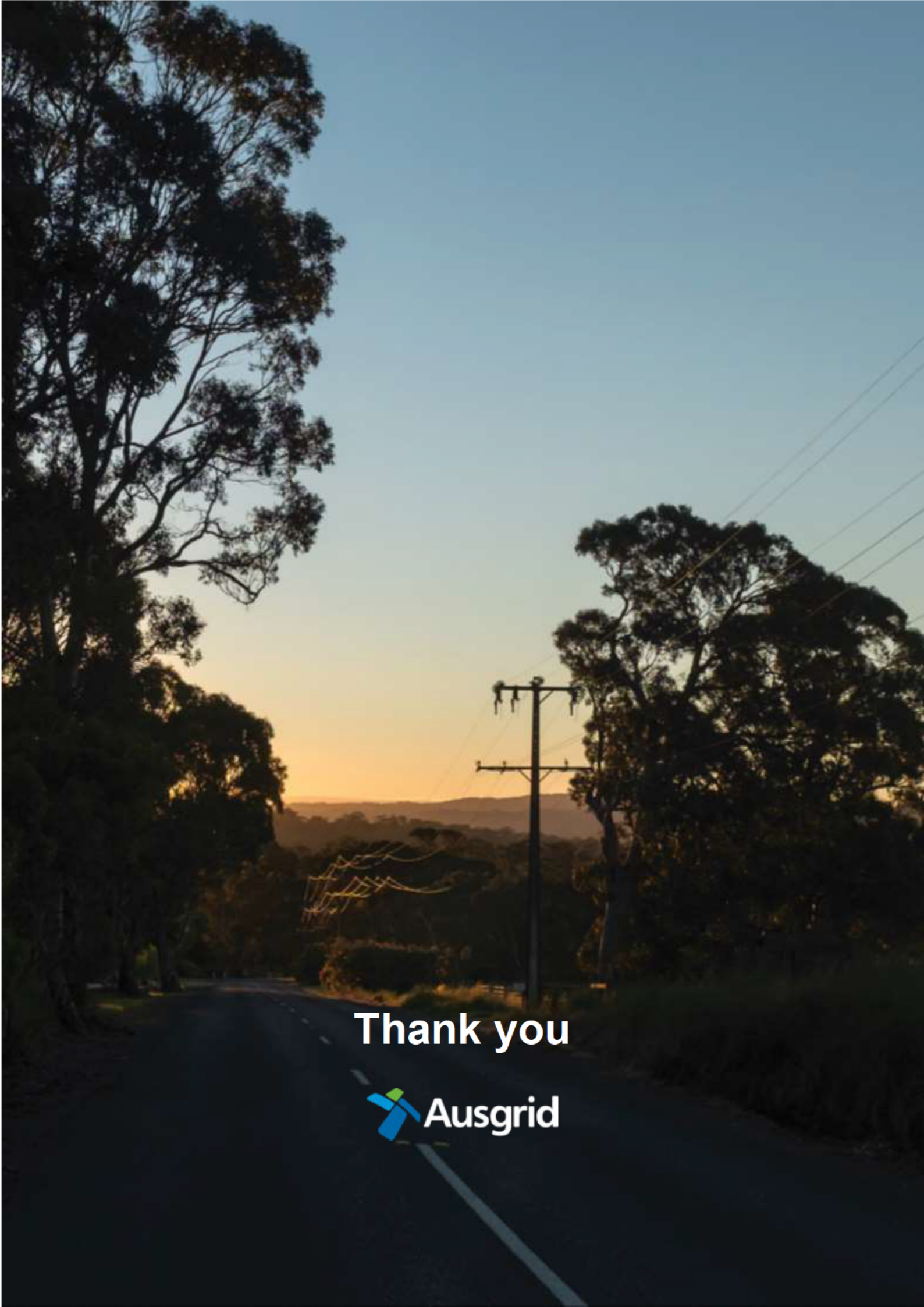
The ENA submission goes into some detail on the practical implementation of scenario testing. We list below the key points Ausgrid suggest would contribute to useful scenario testing:

- test the all the WACC variables in a PTRM (similar to that already prepared by the AER and published alongside the draft working paper)
- run interest rate scenarios based on reasonable sources, for example current yield curves, reversion to average, and negative rates
- no probabilities would be applied because the results would not be applied mechanically to any component of the rate of return
- the AER would consider whether the results indicate that the proposed RORI parameters are sufficiently robust to the scenarios, or whether it needs to re-consider how it has used judgement in setting the parameters
- scenario testing should be run at the time of the RORI, because no adjustment can be made at the time of each determination due to the binding rate of return

Appendix 1: Responses to questions

Question	Response
1. Should a nominal vanilla WACC be used to estimate the allowed rate of return?	Yes.
2: What is the appropriate approach for estimating gearing?	Market-based values are most appropriate and measured over 10 years to remove short-term noise.
3: What is the appropriate value for benchmark gearing?	The value indicated by the chosen methodology.
4: What is the appropriate treatment of hybrid securities in the gearing estimation methodology?	Hybrid securities should be included.
5: What is a suitable method for allocating hybrid securities between debt and equity?	Where the security displays the economic characteristics (i.e. interest payments set mechanically, ranking ahead of equity) of debt, it should be allocated wholly as debt.
6: To what extent should the treatment of hybrid securities in the gearing estimation methodology align with the estimation of equity beta?	Treatment should be consistent across all aspects of the rate of return. Hybrids are independent of shares in a company.
7: Should the data used to inform gamma in the 2018 Instrument continue to be used?	Yes, subject to adding ATO data as noted in question 8.
8: Is the data in the ATO's December 2018 note suitable for informing the utilisation rate?	Yes, ATO data would appear to be an appropriate data source of how companies actually use imputation credits.

9: Should non-resident investors be assumed to derive no value from imputation credits?	Yes, this aligns with the utilisation method used by the AER to estimate gamma.
10: How can profitability measures be used as a possible cross check for informing the overall rate of return?	Historic profitability measures do not provide useful information about whether the new rate of return is adequate.
11: How can RAB multiples be used as a possible cross check for informing the overall rate of return?	RAB multiples do not provide useful information about whether a rate of return is adequate.
12: How can investment trends be used as a possible cross check to inform the overall rate of return?	If investment trends can be appropriately disaggregated into discretionary and non-discretionary spend, assessment of the correlation between investment and rates of return may be a useful cross check.
13: How can financeability metrics be used as a possible cross check to inform the overall rate of return?	Explained in in the financeability section of this submission.
14: Can scenario testing be used to inform the overall rate of return?	Yes, as explained in the scenario testing section of this submission.


Thank you
Ausgrid