**Attachment 9-11: Value of Imputation Credits (Gamma)**

**9.1 Introduction**

In the Draft Decisions the AER concluded that, based on the material currently available, 0.45 is the best estimate of gamma arrived at on a reasonable basis, as required by Rule 74 of the National Gas Rules. The decisions are based on an assumed payout ratio of 70 per cent and a theta estimate of 0.65.[[1]](#footnote-1)

For the reasons set out below, Envestra considers the AER’s decision that 0.45 is the best estimate of gamma arrived at on a reasonable basis to be incorrect. In particular:

1. In making the decision with respect to gamma, the AER has failed to have regard to the decision of the Australia Competition Tribunal of 13 October 2010 in *Application by Energex Limited (No 2)* [2010] A CompT 7 (***Energex No 2***), where the Tribunal found that the AER’s approach to the estimate of theta in the Statement of Regulatory Intent (0.65) was in error.
2. The AER failed to give adequate weight to the evidence and submissions put forward by Envestra in its regulatory proposal that:
   1. Corporate valuation professionals advising company boards and management evaluating potential new investment projects generally make no adjustment in relation to franking credits.[[2]](#footnote-2)
   2. The submissions by Envestra that the AER’s approach results in an inconsistent use of different values for the same parameter in two parts of the WACC estimation process. In particular, inconsistent estimates of the value of cash dividends.[[3]](#footnote-3)

1. Further, the AER has erroneously expressed the view that the payout ratio is in the range of 70% to 100%.

**9.2 Draft Decision**

In the Draft Decisions the AER departs from its previous assumption in the Statement of Regulatory Intent (**SORI**) that the assumed payout ratio is 100%, but maintains its approach to the estimate of theta.

The AER departs from its previous assumed payout ratio on the basis of the Tribunal’s decision in *Application by Energex Limited (Distribution Ratio (Gamma) (No 3)[[4]](#footnote-4))* (**Energex Distribution Ratio decision**) on 24 December 2010 that a value for the payout ratio of 70% was appropriate.[[5]](#footnote-5)

While the AER correctly applies the decision of the Tribunal in that regard, it fails to acknowledge the Tribunal’s earlier decision in the same proceedings that the AER erred with respect to the approach to estimating theta, which gives rise to its point estimate for that integer of 0.65.

In the Draft Decisions the AER continues to apply the approach in the SORI of taking a simple average of the values derived from the Handley and Maheswaran Tax Statistics Study (0.75) and the Beggs and Skeels dividend drop-off Study (0.57) to arrive at a point estimate of theta of 0.65.[[6]](#footnote-6) The Tribunal found this approach to be in error.

In addition the AER has largely ignored the other submissions made by Envestra in its regulatory proposal as to why the best estimate of gamma arrived at on a reasonable basis is 0.2.

**9.3 Distribution Rate (or Payout Ratio)**

In its regulatory proposal Envestra submitted that the appropriate value for the payout ratio is in the range of 0.66 to 0.71. That submission was made on the basis of expert analysis and reports prepared by Officer Hathaway, Synergies and the witness statements of Professor Officer and Peter Feros.[[7]](#footnote-7)

In the Draft Decisions the AER acknowledges that the Tribunal in the *Energex* (Distribution Ratio) decision “*found errors by the AER in its treatment of the imputation credit distribution ratio and the utilisation rate. However the Tribunal did not make a determination on the correct value of gamma and directed the AER to undertake further work and seeks a report from the AER in relation to various aspects of the calculation determination of gamma. One element of this work relates to the payout ratio, where on 24 December 2010 the Tribunal issued a decision finding that, on the basis of the information before it, a value of 70% was appropriate*”.[[8]](#footnote-8)

In its reasoning with respect to the payout ratio the AER states that it does not consider the evidence supports an assumption that retained credits have zero value as implied by Envestra’s submission that the payout ratio lies in a range of between 0.66 and 0.71.[[9]](#footnote-9)

It remains Envestra’s position that the expert evidence and the practice of corporate valuation professionals suggests that the AER’s assumption of a positive value for undistributed credits is inconsistent with the empirical evidence and the requirement in the National Gas Rules that the rate of return be commensurate with prevailing conditions in the market for funds. The AER acknowledges in the Draft Decisions that it is unlikely that there would be a significant payout of retaining imputation credits in the immediate future.

In its reasoning on the payout ratio, the AER continues to express the view, contrary to the very recent findings of the Tribunal in the *Energex* (Distribution Ratio decision), that the estimated value of the payout ratio is within a range of 70% to 100%. The use of the upper bound appears to hinge on the AER’s continued view that retained credits have the same value as distributed credits and may eventually be distributed. For the reasons Envestra submitted in its regulatory proposal, there is no support for that assumption. The weight of evidence is in fact to the contrary. The AER’s own experts previously noted the flaws in the assumption that distributed and undistributed credits have the same value.[[10]](#footnote-10)

Ultimately, the AER applies a payout ratio of 70% in calculating the estimate of gamma for Envestra on the basis that the empirical evidence currently before the AER supports that value.

The AER has adopted that value “*as the best estimate possible under the current circumstances in accordance with Rule 74(2) of the NGR*”[[11]](#footnote-11). While Envestra submits that the payout ratio arrived at by the AER of 70% is correct, particularly given the recent findings of the Tribunal in that regard, it remains of the view that the assumption by the AER that the payout ratio is in fact within a range of 70% to 100% and that retained credits have some value, is in error.

**9.4 Theta**

In the Draft Decisions the AER acknowledges the Tribunal’s determination in *Energex No 2* that both the AER’s treatment of the payout ratio and theta in the SORI were in error.[[12]](#footnote-12)

Notwithstanding this acknowledgment, the AER in its Draft Decisions continued to use the approach in the SORI of averaging the results from the Beggs and Skeels Study and the Tax Statistics Study of Handley and Maheswaran to arrive at an estimate of theta of 0.65.[[13]](#footnote-13)

**9.4.1 Use of Dividend Drop-off Studies to Estimate Theta**

In the Draft Decisions the AER continues to give preference to the Beggs and Skeels dividend drop-off study over the SFG dividend drop-off studies. In fact the AER goes so far as to say that the SFG dividend drop-off study should not be relied upon and that the theta value of 0.57 estimated by Beggs and Skeels “*is the best available estimate*”.[[14]](#footnote-14)

In arriving at this decision, the AER:

1. has failed to have regard to the Tribunal’s findings in *Energex No 2* that the AER erred in its conclusion that there was no persuasive evidence justifying a departure from the value of theta derived from the gamma set in the SORI;[[15]](#footnote-15)
2. the finding by the Tribunal that the Beggs and Skeels study must be regarded with something approaching equal caution to that applying to the SFG study;[[16]](#footnote-16)
3. failed to have regard to the opinion of Associate Professor Skeels (one of the authors of the Beggs and Skeels study) who concluded that the SFG estimate of theta of 0.23 “*is the best such estimate currently available for Australia*”.[[17]](#footnote-17)

Further, the AER’s statement in the Draft Decisions that the theta value of 0.57 estimated by Beggs and Skeels “*is the best available estimate*” is inconsistent with its approach of then averaging that point estimate with the average of values derived from the Handley and Maheswaran Tax Statistics Study. If the AER’s view is that the best estimate of theta is the Beggs and Skeels’ estimate of 0.57 (without acknowledging that in fact it is the best estimate) its approach of then averaging that estimate with the tax statistics studies is illogical.

However the AER did not apply the point estimate of theta from either the Beggs and Skeels or the SFG dividend drop-off studies. Instead it adopted the same approach it used in the SORI, notwithstanding the findings of the Tribunal in *Energex No 2* that that approach was incorrect.

**9.4.2 Tax Statistics Studies**

The Tribunal in *Energex No 2* found that as the figure the AER derived from Handley and Maheswaran of 0.74 far exceeded any estimate for theta from empirical studies, and in particular the estimate from Beggs and Skeels of 0.57, the tax statistics figure did no more than confirm that the Beggs and Skeels figure was not to be ruled out as being too high.[[18]](#footnote-18)

Further, the Tribunal found that there was no logic to the AER’s approach of adjusting the upper bound value of theta derived from Handley and Maheswaran by averaging it with the lower figure estimated for the period 1988 to 2000.[[19]](#footnote-19) The AER also failed to have regard to the Tribunal’s findings that the appropriate way to use the tax statistics figure from Handley and Maheswaran was as a check rather than as an upper bound from which a simple average was taken from the Beggs and Skeels study to arrive at a theta of 0.65.[[20]](#footnote-20)

The criticisms made by the Tribunal of the AER’s use of tax statistics studies in the SORI exposes the error in the approach of the AER in the Draft Decisions.

In addition, the AER’s average of 0.75 derived from the tax studies in Handley and Maheswaran was incorrect. The AER took the value derived for the 1990 to 2000 period (0.67) and the 2001 to 2004 period (0.81) and selected a midpoint to arrive at its point estimate of 0.74. In doing so the AER failed to have regard to the mean value for theta calculated in Handley and Maheswaran (2008) for the entire period 1990 to 2004 of 0.71[[21]](#footnote-21).

Professor Handley himself has expressed the opinion that the tax statistics approach does not itself produce an estimate of gamma but only a theoretical maximum upper bound.[[22]](#footnote-22)

In circumstances where the Tribunal has found that the approach taken by the AER in the SORI that led to an estimate of theta of 0.65 was clearly incorrect, the AER’s continued use of that approach is an error and fails to arrive at a best estimate of gamma as required by Rule 74.

**9.4.3 Further Study in respect of theta**

Envestra understands that SFG is in the process of completing a further dividend drop-off study using a methodology agreed with the AER, as requested by the Tribunal in the *Energex* proceedings. That study is not available as at the date of this submission.

Envestra understands that the final SFG report will be lodged with the Tribunal shortly after submission of Envestra’s revised regulatory proposal. Given the importance of this study and the AER’s acknowledgment that “*Any Tribunal decisions on this matter will be taken into account by the AER at the time of the final decision for Envestra*”,[[23]](#footnote-23) Envestra will provide any further submissions arising from the final report lodged by SFG in the *Energex* proceedings as soon as possible after the report has become available.

**9.5 Other Submissions made by Envestra**

Envestra repeats the submissions it made in its access arrangement information of September 2010 with respect to the inconsistent approach of the AER in its interpretation of empirical studies with market value of cash dividends and imputation credits.

In relation to the practice of corporate valuation professionals, Envestra made extensive submissions with respect to the prevailing market practice in its access arrangement information. The AER in its Draft Decision states that “*This practice does not necessarily imply that market practitioners unequivocally believe that imputation credits have zero value, and may simply assign a value of zero for a variety of reasons, including the complexity uncertainty in estimating true value*”[[24]](#footnote-24).

This statement suggests that corporate valuation professionals do not have adequate regard to their obligations and duties in preparing valuation reports. Corporate valuation professional have an obligation to select a value for gamma which considers would give the most appropriate valuation. Grant Samuel in a Valuation for Origin Energy stated:

*Accordingly, while franking credits may have value to some shareholders they do not affect the underlying value of the company itself* [or the discount rate used to value that company]*. No value has therefore been attributed to Origin’s accumulated franking credit position in the context of the value of Origin as a whole*.”[[25]](#footnote-25)

This is an example of a very experienced corporate valuation professional applying “no value” to accumulated franking credits on the basis imputation credits do not affect the underlying value of the company. The AER in its Draft Decision has failed to have regard to the practice of corporate professionals such as Grant Samuel.

Further, the statement by the AER fails to have regard to the submission by Envestra that as Rule 87 requires a rate of return to be set which is commensurate with prevailing conditions in the market for funds, substantial regard should be had to the practice of corporate valuation professionals in the marketplace.

**9.6 Conclusion**

Envestra’s submission is that the value of gamma of 0.45 adopted by the AER is not the best estimate of gamma arrived at on a reasonable basis because:

* The AER erroneously considers that the payout ratio is within a range of 70% to 100%, but uses a value of 70% in the Draft Decisions.
* The AER continues to use an estimate of theta of 0.65 using the incorrect methodology adopted in the SORI, contrary to the findings of the Tribunal in *Energex No 2*.
* The AER’s decision that adoption of a gamma of 0.45 is consistent with revenue and pricing principles, the National Gas Objective and is the best estimate arrived at on a reasonable basis does not have regard to the practice of corporate valuation professionals.

The best estimate for gamma arrived at on a reasonable basis is submitted by Envestra to be 0.2, applying a distribution ratio of 0.7 and a theta of 0.3 (based on the SFG study presently available).

Envestra submits that this estimate is consistent with the objectives of the National Gas Rules, the SFG empirical analysis, supports a BBB+ credit rating and is consistent with other revenue setting parameters.

1. Draft Decision (QLD) page104, Draft Decision (SA) page 112. All references in this section to the Draft Decisions are to the page numbers appearing in the public versions of the QLD/SA Draft Decisions. [↑](#footnote-ref-1)
2. Envestra Limited Queensland Access Arrangement Information September 2010, page 154, in Section 10.6.5 and SA Access Arrangement Information, September 2010, page 161 and 172-174. [↑](#footnote-ref-2)
3. Qld Access Arrangement Information September 2010 page 159 and 162 to 163, SA Access Arrangement Information, September 2010, pages 167-170. [↑](#footnote-ref-3)
4. [2010] A CompT 9. [↑](#footnote-ref-4)
5. Draft Decision (QLD) page 98, Draft Decision (SA) Page 106. [↑](#footnote-ref-5)
6. Draft Decision (QLD) page 100, Draft Decision (SA) page 107. [↑](#footnote-ref-6)
7. Qld Access Arrangement Information September 2010 page 154 and Attachment 10-4, SA Access Arrangement Information, September 2010, page 162 and Attachment 10-4. [↑](#footnote-ref-7)
8. Draft Decision (QLD) page 98, Draft Decision (SA) page 106. [↑](#footnote-ref-8)
9. Draft Decision (QLD) page 100, Draft Decision (SA) page 108. [↑](#footnote-ref-9)
10. McKenzie and Partington and Professor John Handley. See Qld Access Arrangement Information September 2010, page 157 and SA Access Arrangement Information, page 165. The reports were included in Attachment 10-4 to Envestra’s AAI September 2010. [↑](#footnote-ref-10)
11. Draft Decision (QLD) page 101, Draft Decision (SA) page 108. [↑](#footnote-ref-11)
12. Draft Decision (QLD) page 98, Draft Decision (SA) page 106. [↑](#footnote-ref-12)
13. Draft Decision (QLD) page 104, Draft Decision (SA) page 112. [↑](#footnote-ref-13)
14. Draft Decision (QLD) page 102. Draft Decision (SA) page 110. [↑](#footnote-ref-14)
15. *Energex No 2,* paragraph 89. [↑](#footnote-ref-15)
16. *Energex No 2,* paragraph 139. [↑](#footnote-ref-16)
17. Christopher Skeels “A Review of the SFG Dividend Drop off Study” 28 August 2009, page 31. (Submitted in Attachment 10-4 to Envestra’s AAI), (September 2010). [↑](#footnote-ref-17)
18. *Energex No 2*, paragraph 92 [↑](#footnote-ref-18)
19. *Energex No 2*, paragraph 95. [↑](#footnote-ref-19)
20. *Energex No 2*, paragraph 91. [↑](#footnote-ref-20)
21. Handley and Maheswaran: A Measure of the Efficacy of the Australian Imputation Tax System, The Economic Record, Volume 84, No 264, March 2008, 82-94, at page 90. Contained in Attachment 10-4 to Envestra’s AAI, September 2010. [↑](#footnote-ref-21)
22. ”Report prepared for the Australian Energy Regulator on the Estimation of Gamma” 19 March 2010, page 15 (Attached). Contained in Attachment 10-4 to Envestra’s AAI, September 2010. [↑](#footnote-ref-22)
23. Draft Decision (SA) page 113 [↑](#footnote-ref-23)
24. Draft Decision (QLD) page 104, Draft Decision (SA) page 112. [↑](#footnote-ref-24)
25. Grant Samuel, ‘Valuation for Origin Energy of ConoccoPhillips offer to acquire shares in Origin Energy CSG Limited (prepared for purposes of assessing the British Gas Bid for Origin Energy)’, 15 September 2008, page 130. (Submitted in Attachment 10-4 to Envestra’s AAI, September 2010. [↑](#footnote-ref-25)