Attachment 01.10

Return on Debt Transition

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PowerWater

Contents

1. Our rationale in short

This attachment explains our rationale for proposing a trailing average approach to determining the return on debt allowance for us, rather than adopt the 10 year transition preferred by the Australian Energy Regulator (AER).

We understand the AER's preference

The AER has adopted a 10 year transition to the trailing average return on debt in all recent decisions for the network service providers (NSP's) that it regulates. We understand the AER's reasons for this and considered them when preparing our regulatory proposal.

We agree that a trailing average approach best serves the long term interests of consumers. We also accept that a distribution network service provider (DNSP) should not receive a windfall gain when adopting that approach – and consumers should not be asked to (effectively) pay twice for the same high period in the interest rate cycle.

However, in our circumstances a transition is not appropriate

We have effectively been operating under a trailing average return on debt allowance for some time, with both our effective allowance and our actual costs aligning with such an average. This is a noticeable difference from other DNSP's regulated by the AER.

As explained in subsequent chapters, it would therefore be inappropriate to transition to the trailing average return on debt allowance – as we are already there. A transition would mean that we are undercompensated for our efficient debt financing costs. It would also ignore the reality that this is our first decision under the National Electricity Northern Territory (NT) Rules (NT NER) and that our current revenue allowance was set by Ministerial Direction.

Moreover, we do not have any complicated hedges or other financial transactions that need to be unwound through transition.

We will not receive a windfall gain

Adopting the trailing average approach immediately would *not* provide us a windfall gain – which, understandably, has been a key concern of both the AER and consumers.

This is because, unlike other service providers regulated by the AER, the effective allowed return on debt reflected in our current tariffs (~4.21%) is significantly below the on-the-day rate that would have applied at the start of the 2014-19 period, as reflected in the Ministerial Direction that set our revenue allowance for that period (see Box 1 in section 3.2). Averaging that effective allowance with the Utilities Commission (UC) determined return on debt allowance for the prior (2009-14) period (8.51%), gives a value (6.36%), –

which is consistent with the 10-year trailing average that we propose for the first year of the 2019-24 period (6.37%). [1]

In other words, in combination, the UC decision for the 2009-14 period and the Ministerial Direction for the 2014-19 period give us an effective trailing average return on debt allowance over the 2009-19 period.

This starting point is unique among DNSP's – and means that if we were given the trailing average allowance for the next (2019-24) period (as proposed), we would **not** receive a windfall gain. Instead, we would effectively continue the trailing average that we received over the 10 years from 2009.

Our consumers will not pay twice

Moreover, us not receiving a windfall gain means that our consumers will not pay twice for the high interest rates observed historically.

This is further reinforced by proposing that the trailing average does **not** include the rates observed during the peak of the global financial crisis (GFC) over 2008 and early 2009 – as the averaging period used to apply that approach need only stretch back to July 2009 (indicated by the vertical line in Figure 3.1 below).

We explain our rationale further below

For the remainder of this attachment, we:

- **discuss** the circumstances where transition is appropriate (chapter 2);
- **consider** whether a transition is appropriate for us (chapter 3); and
- **conclude** by assessing our proposal against recent AER decisions, and the NT NER (chapter 4).

[1] The simple average of 4.21% and 8.51% is 6.36%.

2. When transition is appropriate, or not

Setting of return on debt allowances has been contentious in recent regulatory decisions – and for good reason. Firms, consumers, their representatives, and the AER have been evolving their thinking on the rationale for various approaches to determining the return on debt.

Before we explain our rationale for adopting the trailing average approach (in chapters 3 and 4), we first compare it to the on-the-day approach and the rationale for transitioning between the two.

2.1 Different approaches lead to different outcomes

Several approaches could be used to set the return on debt allowance. For present purposes, we focus on just two:

- **The on-the-day approach** – where the return on debt allowance is reset at the start of each regulatory period (usually every 5 years) to reflect the returns prevailing at the time. 'Prevailing' typically refers to an averaging period, 10 to 40 business days in length, occurring just prior to the start of the regulatory period. As explained below, this can lead to large swings in revenue allowances (and, therefore, prices) as prevailing rates reflect changes in market conditions at that point in time, such as during the GFC.
- **The trailing average approach** – where the return on debt allowance is updated annually to reflect the average returns observed over some historical period, say 10 years. This is effectively the average of the rates prevailing over that longer period. As we move from one year to the next, the oldest returns in the average are removed and replaced with new ones. Using a 10-year period means that the return on debt allowance is much less volatile than one set using the on-the-day approach, as temporary jumps in prevailing returns are averaged out and sustained changes take time to be reflected.

These approaches, although different, are on average likely to lead to the same level of revenue to firms – and cost to consumers – in the longer term. However, they reflect quite different risk profiles.

The on-the-day approach can lead to swings in allowances and prices, as has been seen through past regulatory decisions. Consumers face this risk of swings. However, firms – in some circumstances – can hedge those swings by aligning their debt costs to the allowance using hedges such as interest rate swaps or by issuing debt in line with the resetting of those allowances. Most consumers *cannot* hedge.

The trailing average is much slower to move. Using a 10-year average, for instance, means that new observed returns for a given year make up only 1/10 of the average – and so have a limited effect on that average. Revenue allowances and prices are therefore much more stable over time. Firms can issue debt or hedge to match that allowance, and consumers avoid price shocks.

The higher risk faced by consumer under the first approach is a key reason that the Major Energy Users proposed a change to the way return on debt allowances are calculated. We concur with the rationale for that proposal.

The difference can also be shown graphically using stylised examples, as we do in the next section.

2.2 Stylised examples

We look at two examples. The first looks at the on-the-day approach. The second looks at the trailing average approach.

2.2.1 On-the-day approach

Figure 2.1 shows the example where the return on debt allowance is set using the on-the-day approach at the start of each regulatory period. The orange line represents the prevailing return on debt – which we have assumed (for simplicity) follows up and down cycles. The green horizontal line segments represent the return on debt allowances, set using the prevailing return on debt at the start of each period.

As you can see, under the on-the-day approach, movements in the prevailing return on debt can lead to significant movements in the return on debt allowance. This in turn can lead to significant swings in prices faced by **consumers** as they adjust to reflect the return prevailing at the start of each regulatory period.

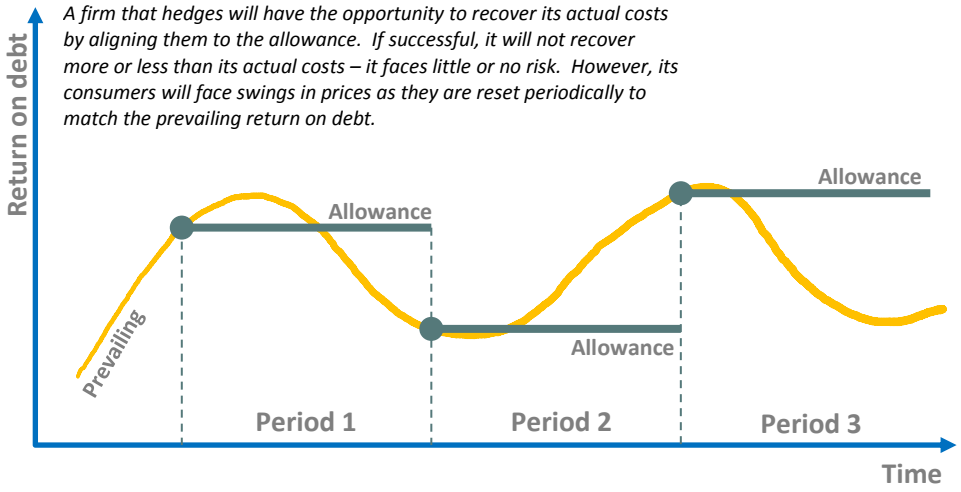
The impact to the **firm**, however, will depend on its debt management practices. A firm that hedges – as shown in Panel A – will have the opportunity to recover its costs without the risk of under or over recovery. In contrast, a firm that does not hedge – as shown in Panel B – will face some risk, as at any point in time the allowance it receives could be more or less than its actual costs (assuming that they more or less reflect a trailing average).

Now, this is not to say that either debt management practice is inefficient. For some firms it may not be possible to hedge effectively, or considered too costly to do so. Other firms may consider that the under or over recovery from not hedging will balance out (in NPV terms) in the longer term (or that they can outperform the allowance), and be willing to face risk in the short term – in which case they may 'bank' over-recovery in one period to fund under-recovery in another, or 'borrow' and 'repay' in the reverse.

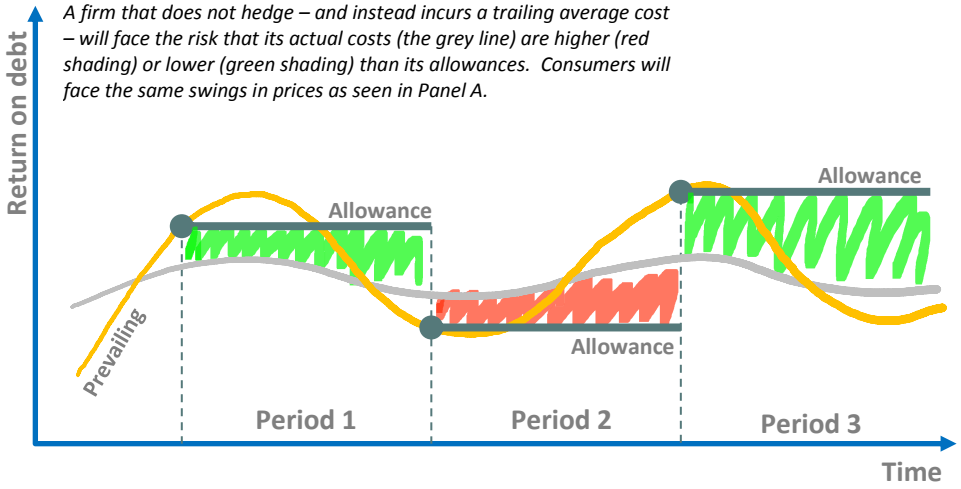
The key is that – under an on-the-day approach – a firm generally has a choice over what risk it faces, but consumers do not (putting to one side a sophisticated consumer that may undertake some hedging of his or her own).

Figure 2.1: Stylised example 1 – on-the-day approach to setting the return on debt allowance

PANEL A: A firm that hedges to the allowance



PANEL B: A firm that does not hedge to the allowance



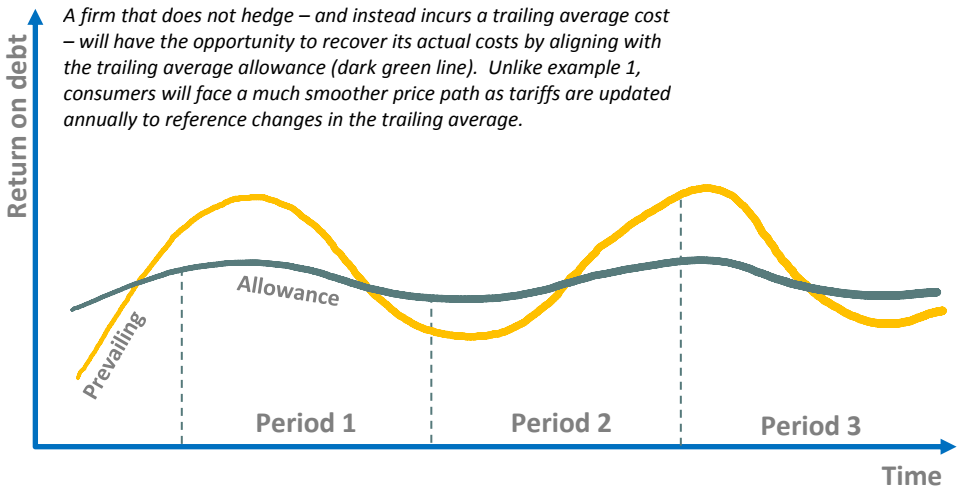
2.2.2 Trailing average approach

Figure 2.2 shows the example where the return on debt allowance is set using the trailing average approach, and updates each year throughout the regulatory period. Again, the orange line represents the prevailing return on debt – which we have assumed (again for simplicity) follows up and down cycles. The dark green line represents the trailing average return on debt, and in this example reflects *both* the allowance and the firm's costs.

As you can see, in contrast to the on-the-day approach, the trailing average approach results in a much more stable return on debt allowance. **Consumers** – and firms – face much more stable prices both within a regulatory period and across periods.

A **firm** faced with such an allowance does not need to hedge, although some may if they do not stagger their debt issuance over time (e.g. because they are too small).

Figure 2.2: Stylised example 2 – trailing average approach to setting the return on debt allowance



2.3 Transitioning between approaches

Over the longer term the two approaches are expected to provide the same level of revenue to firms and costs to consumers. However, this does not mean that one can just switch from one to the other and assume that there are no windfall gains or losses.

At any point in time there can be large differences between the two approaches in terms of the compensation provided to firms – and whether they are under or over recovering their costs – and in terms of the costs to consumers. If a firm is over-recovering in one period and is expected to under-recover in the next (e.g. because prevailing returns have dropped), then it would gain by jumping straight to a trailing average that avoided that under-recovery. Conversely, if the firm was under-recovering in one period and expected to over-recover in the next, then it would lose by jumping straight to a trailing average. We understand these differences.

In these circumstances, a transition between one method and the next is likely warranted. Such a transition would ensure that firms – and consumers – face the same expected outcomes whether there was a change in method or not.

This analysis is important because we do *not* face this circumstance. As explained below, both our actual debt costs and our effective return on debt allowance reflect a trailing average. If we are trying to get to a trailing average, then applying a transition would lead to significant under-compensation for us.

3. What is appropriate for us

Recognising that a transition between methods *may* be appropriate in some circumstances, we need to consider whether these circumstances apply to us.

Our conclusion – as explained in this chapter – is that they do not. In fact, applying such a transition would mean that we are under-compensated for our efficient financing costs over the 2019-24 period.

3.1 We are already operating under a trailing average allowance

Explaining why is important.

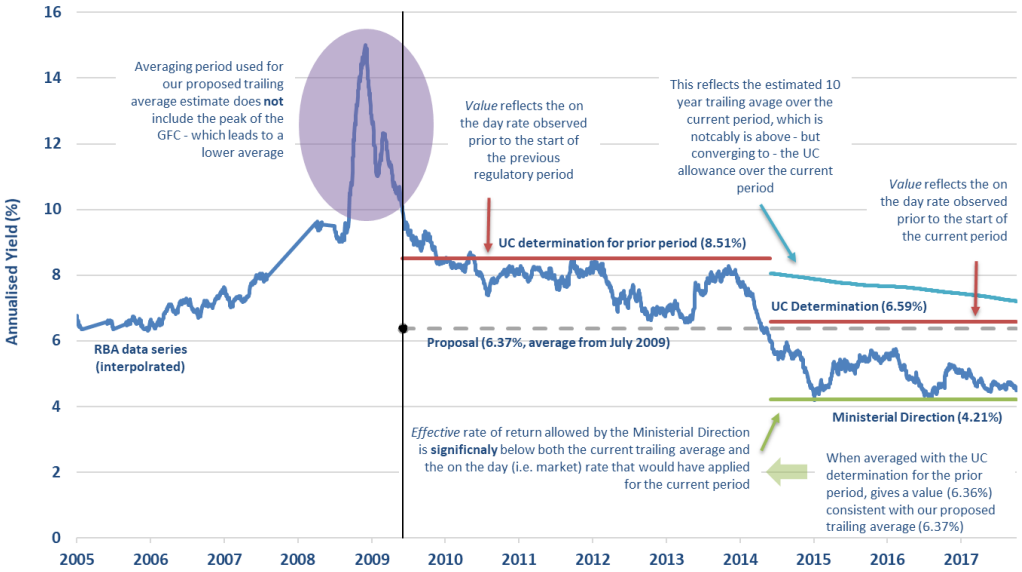
Figure 3.1 compares the historical prevailing return on debt back to 2005 (the blue line that moves up and down) to UC Determinations (the red horizontal line segments) and Ministerial Direction (the green horizontal line segment). Clearly, prevailing returns swung up to the peak of the GFC in 2008 and have fallen since. The UC's allowed rates of return over the 2009-14 and 2014-19 periods have followed that decline. The Ministerial Direction – which has set our current period tariffs – has gone further than the decline.

This comparison shows that:

- the allowed return on debt reflected in our current tariffs (~4.21%) is significantly below the on-the-day rate that applied at the start of 2014-19 period, and that determined by the UC (6.59%); and
- averaging our current effective return on debt allowance (~4.21%) with that determined by the UC for the 2009-14 period (8.51%) gives a value (6.36%) – which is consistent with the 10-year trailing average that we propose (6.37%) (see Figure 3.1 below).

These circumstances contrast to those stylised in chapter 2. We are not in an over-recovery period and do not expect to under-recover in the next period. We are instead faced with the situation where – when looked at over a 10-year period – both our return on debt allowance and, as explained below, our actual debt costs reflect trailing averages already.

Figure 3.1: Prevailing versus trailing average return on debt



Source: Reserve Bank of Australia (RBA) for prevailing return on debt (in blue). UC and the Minister allowed for rates of return (in red and green).

This means that we are *not* transitioning from a rate on the day to a trailing average – we are, in effect, already operating in a trailing average regime when looked at over a 10-year period. Both the current period revenue (when combined with our previous period revenue) and our debt management practices reflect a trailing average.

We will not receive a windfall gain by using a trailing average to set the return on debt allowance for the 2019-24 period and consumers will not pay twice for the higher rates observed during the peak of the GFC, as the higher rates reflected in the return on debt allowance for the 2009-14 period are offset by the effective rate of return allowance mandated for the 2014-19 period (which is well below observed rates). Rather, a trailing average would simply provide a return that is reflective of the efficient debt financing costs and consistent with the allowed rate of return objective (**ARORO**), as explained in chapter 4.

Importantly, Figure 3.1 also overlays our proposed trailing average (the dotted grey line). As noted in chapter 13 of our regulatory proposal, we propose using an averaging period to apply the trailing average approach that starts in July 2009. This average does not include the prevailing interest rates observed during the peak of the GFC over 2008 and early 2009. As a result, our consumers are not being asked to pay twice for these historically high interest rates.

3.2 Our current period allowance does not reflect an on-the-day rate

Our effective return on debt allowance for the current regulatory period was not set by the AER and does not reflect an on-the-day rate. Therefore, unlike all other NSP's regulated by the AER, there is nothing to transition *from*. In our view, it would make little sense – and be unfair, or otherwise inconsistent with the ARORO – to impose a transition *as if* returns in the current period reflected an on-the-day methodology.

For the 2014-19 period the Minister, using his powers under the Government Owned Corporations Act, directed us to adopt a lower revenue allowance. As both our only shareholder and long-term debt financier, the NT Government was willing to receive lower returns so that NT consumers would benefit through lower prices – reflecting its ongoing commitment to realising low and more stable prices for consumers. This direction was codified in the NT NER within rule 6.4.3(a)(5A), where any under or over recovery of allowed revenue from the 2014-19 period carried over to the 2019-24 period must be determined by reference to that direction.

The impact of this direction was that the on-the-day approach was not used to set our effective rate of return allowance, including our return on debt allowance. We instead faced a revenue path that was much more consistent with a trailing average – a revenue/price path that would be smoother over time, with less severe upswings and corresponding downswings. The effective return on debt allowed for the 2014-19 period resulting from this direction is in fact much lower than what would have been allowed under either the on-the-day approach or the trailing average approach, as shown in Figure 3.1 above (the cyan line represents the trailing average over the current period).

We calculate that the effective rate of return allowed for the current period to be approximately 4.21% – just ten basis points above the risk-free rate for the same regulatory period that was used in the UC's Determination (see Box 1 below).

Box 1: Revenue path and allowed revenues for the 2014–2019 period

Our revenues and prices for the current regulatory control period have been subject to a Ministerial Direction issued under s 8 of the Government Owned Corporations Act (NT), which we are required to follow. This direction provides for revenues that are significantly lower than what was allowed by the UC in the 2014 Network Price Determination (now administered by the AER). Whereas the Network Price Determination provided for total allowed revenue of $1,034.2 million ($nominal), the Ministerial Direction provides for total revenue of $855.7 million ($nominal). The revenue path under the Ministerial Direction is commensurately lower (see Table 3-1 below).

Table 3-1: Revenue paths under the 2014 Network Price Determination and Ministerial Direction

%, real changes	2014-15	2015-16	2016-17	2017-18	2018-19
2014 Network Price Determination	29.8	8.0	3.0	-2.0	-2.0
Ministerial Direction	7.7	8.0	0.0	0.0	0.0

We estimated that the implied return on capital under the revenue path directed by the Minister.[2] We have effectively been allowed a nominal pre-tax return of just 4.21% on the value of its regulatory asset base (RAB) – this is just ten basis points above the risk-free rate for the 2014–2019 regulatory period used in the UC Determination.

Our calculation is shown in Table 3-2 below, which assumes that the RAB is 100% debt funded. If the RAB were partially equity-funded (requiring a higher return on that portion), then the implied return on debt would be even lower. Our full calculation is included at Attachment 12.21, which is a version of the UC allowed revenue model for the 2014–19 regulatory period updated to reflect the Ministerial Direction.

Table 3-2: Calculation of implied rate of return for the 2014–2019 period

Total allowed revenue (per Ministerial Direction)	**$855.7 million**
Operating & maintenance expenditure (per UC Determination)	$467.0 million
Regulatory depreciation (per UC Determination)	$143.9 million
Carryover adjustments (per UC Determination)	$42.0 million
Implied return (including tax)	$202.8 million
Implied nominal pre-tax rate of return	4.21%

[2] Although the direction did not explicitly determine an allowed rate of return, it did make clear that the revenue reduction 'reflects a reduction in the return that the Territory expects to earn from its investment in the Power and Water Corporation'. The NT Government provides both debt and equity funding to Power and Water. See, Letter from David Tollner to Ken Clarke, *RE: Ministerial Direction to Power and Water Corporation in relation to implementation of alternative revenue path for the 2014-19 regulatory control period*, 6 June 2014, p. 1.

We raise this not because we are looking to recover the shortfall between the Ministerial Direction and the UC allowance for the 2014-19 period. We accept that this would be inconsistent with providing *ex ante* efficient compensation through the allowed rate of return and – importantly – with the intent behind the Ministerial Direction.

However, that direction effectively meant that NT consumers did not have to pay the higher prices that would have applied *if* the high interest rates observed just prior to the start of the current period were used to set revenues and tariffs (using the rate on-the-day approach). NT consumers did not face the price volatility that can result from applying that approach – as discussed in section 2.2.1. In effect, the direction smoothed our prices and revenue in a way that aligned to a trailing average return on debt allowance.

Rather, we raise it because how our effective return on debt allowance was set for the current regulatory period is directly relevant to what, if any, transition is appropriate in the next period. Unlike other NSP's regulated by the AER, our revenue for the *current* period is not based on an on-the-day rate – and so to implement a trailing average approach for the *next* regulatory period we are not switching from an on-the-day allowance.

In fact, our effective revenue allowance for the current period does not incorporate a return on debt allowance based on *any* particular methodology. As noted above, this implied return on debt does not reflect the efficient financing costs of Power and Water or a relevant benchmark efficient entity incurred over the current regulatory period, and therefore – in our view – would not satisfy the ARORO by itself.

As such, the Ministerially-directed revenue path:

- cannot have created any expectations as to the future return on debt methodology; **nor**
- can it mean that applying the trailing average approach in the next regulatory period would change the present value of capital investments from what would have been implied by a previous methodology,

because no obvious or explicit methodology underpins that revenue path.

3.3 Our current debt portfolio already aligns to the trailing average approach

Unlike many other NSP's that are regulated by the AER, we hold a staggered debt portfolio and have not used any form of hedging instrument – such as interest rate swap contracts. Our debt funding is provided by the NT Government periodically over time. We have some debt that is almost ten years old, and other debt that is new. That is, we already have a debt structure that is amenable to the trailing average approach.

Putting to one side (for now) the relevance of our actual circumstances, these may be contrasted with those of some other network service providers who either hold no debt or have a debt structure that is *not* amenable to a trailing average (e.g. because they have used hedging instruments). For those NSP's, the Federal Court and the Australian Competition Tribunal (Tribunal) have

observed that a transition may be required, either because it is needed to unwind financial contracts or because doing otherwise may lead to a windfall gain.

For instance, the Federal Court has observed that, in circumstances where a network service provider already has a debt structure that is amenable to the trailing average approach and that structure is not complicated by hedging contracts that need to be unwound, there is no need to impose a transition to the trailing average approach.[3] In such circumstances, the trailing average approach can be implemented immediately in accordance with clause 6.5.2 of the NT NER. The corollary is that a transition *may* be required for network service providers that have hedged.

Similarly, for NSP's that do not hold any debt, the Tribunal has observed that implementing the trailing average approach immediately may lead to a windfall gain.[4]

Evidently neither of these circumstances apply to us, given that we *do* hold a staggered portfolio of fixed rate debt without any hedges. While some network service providers whose revenue is set based on the rate on the day approach may choose to hedge to fix those interest rates, for us – where prices were set for the 2014-19 period consistent with much lower rates than the 'on the day' rates – hedging would lock in an 'out of the money' position.

In our case, therefore, there would be no "windfall" – in any sense – associated with applying the trailing average approach immediately.[5] Rather, the trailing average approach would simply provide a return on debt that reflects an efficient financing practice engaged in by us.

In these unique circumstances, a transition would make little sense. As noted above, we already have a debt structure that is amenable to the trailing average approach. Our current revenues do not incorporate a return on debt allowance based on the on-the-day methodology, or indeed any methodology. In short, there is nothing to transition from. The trailing average approach can be implemented immediately for us as this is the first regulatory period in which the AER will be regulating the return on debt allowance.

It would be unreasonable to transition from an on-the-day approach, where that approach is not the basis for our current tariffs, and where doing so

[3] Australian Energy Regulator v Australian Competition Tribunal (No 2) [2017] FCAFC 79, [572].

[4] In *Application by ActewAGL Distribution* [2017] ACompT 2 (at [144]), the Tribunal expressed concern that immediate application of the trailing average approach for businesses that hold no legacy debt may lead to a "windfall gain".

[5] In *Application by ActewAGL Distribution* [2017] ACompT 2 (at [144]), the Tribunal expressed concern that immediate application of the trailing average approach for businesses that hold no legacy debt may lead to a "windfall gain". Evidently this would not be the case for PWC, given that PWC does hold a staggered portfolio of fixed rate debt.

would compensate us below what is efficient for our debt portfolio (in terms of what would satisfy the ARORO). Imposing a transition would, in effect, impose a penalty on us without having caused any harm – which would be wrong. In contrast, an immediate adoption *would* be fair and – as explained in chapter 4 – and be consistent with recent AER, Tribunal and Federal Court decisions.

4. What the rules require

Having explained the rationale for transition and why that does not apply to us, this chapter shows how our proposal is consistent with AER positions and the NT NER.

4.1 A trailing average approach best serves the long-term interest of consumers

We agree with the AER that the trailing average approach is likely to contribute to achieving the ARORO.[6] As acknowledged by the AER, the trailing average approach recognises the desirability of minimising any difference between the return on debt and the return on debt of a benchmark efficient entity referred to in the ARORO.[7]

The trailing average approach avoids the significant swings – both up and down – in return on debt allowances that can come from resetting it every five years using the on-the-day approach, especially at the peaks and troughs of the interest rate cycle. The trailing average approach is intended to follow a smoother path through that cycle, avoiding the extremes, as shown in section 2.2.

This 'smoothing' benefits both our consumers – by avoiding the risk of higher prices – and network service providers like us. The trailing average approach allows a network service provider to manage interest rate risk arising from a potential mismatch between the regulatory return on debt allowance and the expected return on debt of a service provider, without exposing itself to substantial refinancing risk.[8]

The trailing average approach provides an estimate of the return on debt that is commensurate with the financing costs that would be incurred by a firm operating in the manner of a firm in a competitive environment. Expert advice demonstrates that firms operating in a competitive environment would be expected to hold a staggered portfolio of fixed rate debt.[9] The debt

[6] AER, *Rate of Return Guideline: Explanatory Statement*, December 2013, pp 108-109.

[7] AER, *Rate of Return Guideline: Explanatory Statement*, December 2013, p 109.

[8] AER, *Rate of Return Guideline: Explanatory Statement*, December 2013, p 108.

[9] Chairmont, *Cost of Debt: Transitional Analysis*, April 2015, p 38. At page 38, Chairmont references UBS' statement that: 'The 'trailing average' approach used by Networks NSW was consistent with debt management strategies adopted by non-regulated entities in the infrastructure sector – ports, airports, road and railways': UBS, *UBS Response to the TransGrid Request for Interest Rate Risk Analysis following the AER Draft Decision of November 2014*, undated, p 5.

See also: Frontier Economics, *Cost of Debt Transition for NSW Distribution Networks*, January 2015, pp 8-9.

See also: CEG, *Efficiency of Staggered Debt Issuance*, February 2013, [92] and [97].

financing costs of a staggered fixed rate debt portfolio align closely to the debt costs calculated under a trailing average approach.

As explained above, the assumptions underpinning the trailing average approach are also consistent with our debt management practices. We hold a staggered portfolio of fixed rate debt, consistent with what may be expected of firms operating in a competitive market environment. Hence, the debt financing costs faced by us in the next regulatory period will reflect an average of rates prevailing at the time each tranche of debt was raised.

In short, the trailing average approach will provide an allowance that reflects the costs associated with our current financing practice – which is an efficient financing practice and is consistent with what may be expected in a workably competitive market.

Moreover, as explained below, immediately adopting the trailing average approach will, in our unique circumstances, provide correct compensation in a present value sense (or an allowance that meets the NPV = 0 investment condition).

4.2 Given our unique circumstances, there is no need to transition to the trailing average approach

In recent decisions for other network service providers, the AER has determined that a revenue-neutral transition should apply to NSP's that have previously been subject to the AER's on-the-day approach, on the basis that:[10]

- the ARORO requires that the allowed rate of return appropriately compensates investors for capital investments (when looking forward) and aims to minimise the long run cost of capital (all else being equal) – this means that a forward-looking allowed *return* on capital is efficient where its present value matches the forward-looking *cost* of capital cash flows required to finance the RAB (the NPV = 0 investment condition);
- the trailing average approach can provide an allowance that is consistent with the ARORO – under the trailing average approach, *ex-ante* efficient compensation is unlikely to hold for each regulatory period, but is likely to hold over the term of the RAB; and
- in circumstances where an NSP has previously been subject to an on-the-day approach, switching immediately to a trailing average approach is likely to change the present value of capital investments, resulting in under or over-compensation – this would not be consistent with the ARORO.

[10] For example: AER, *Draft Decision: TransGrid transmission determination 2018 to 2023, Attachment 3 – Rate of return*, September 2017, pp 3-110 – 3-121 and Appendix J.

This has understandably led the AER to impose a gradual (ten year) transition to the trailing average approach for those network service providers that have previously been subject to the AER's on-the-day approach.

However, our circumstances are materially different to any of the other NSP's regulated by the AER. As explained in chapter 3, we have:

- effectively faced a trailing average return on debt allowance over the last two regulatory periods; and
- funded our network investment and operations using a staggered portfolio of debt in a way that aligns to a trailing average.

Adopting a trailing average approach to determine the return on debt allowance (without transition), therefore, is entirely consistent with these circumstances. There is no windfall gain (or loss) created by adopting it immediately as we are already there. Our costs and our revenue allowance will continue to align. This is consistent with the ARORO and previous AER positions.

4.3 Even if those circumstances are not relevant, we are having our return on debt set for the first time under the NT NER

As noted in chapter 4 of our regulatory proposal, we are moving from specific NT regulation to national regulation by the AER. This will be our first determination made under the NT NER, and the rate of return rules. Our previous effective return on debt allowance was made by Ministerial Direction, without any apparent reference to similar rate of return rules.

Therefore, for the purposes of applying the AER's NPV=0 principle, the next regulatory period is properly viewed as the *first* regulatory control period for us under the NT NER. The 2019-24 period will also be the first period in which we are subject to a revenue determination – including a determination of the return on debt allowance – made by the AER that references the ARORO or a similar efficiency objective. Our allowed revenues for the current period have not incorporated a return on debt allowance based on any particular methodology, or an outcome that is consistent with the ARORO.

From this perspective, therefore, applying the trailing average approach immediately would be consistent with the AER's NPV=0 principle. The AER has observed that under the trailing average approach, the NPV=0 condition is likely to hold over the term of the RAB. We agree with this.

The AER considers that this principle will only be breached where there is a change in methodology from a previous period that alters the present value of capital investments. Such a change does not apply here, either because there is no previous period or because, in our circumstances, our actual costs and revenue allowance already reflect a trailing average in that previous period.