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Dear Mr Anderson

**RE: Submission in relation to the first round of regulatory determinations under the new rules**

United Energy, (UE), provides this submission in relation to each of the draft determinations set out in Attachment A. These determinations are the first to apply the new National Electricity Rules and National Gas Rules adopted in 2012 by which the AER is to determine the cost of capital allowance for energy network businesses.

These new rules apply a common framework to all energy networks and replace three different sets of rules that applied to each of electricity transmission, electricity distribution and gas pipelines and as such the matters that are raised in the draft decision affect all energy networks.

The new rules were intended to constitute a significant reform to the pre-existing arrangements which, for the electricity sector, involved moving away from the tightly prescribed use of:

- The SL-CAPM model for establishing the allowed rate of return for equity; and
- The “on the day” method of determining the allowed rate of return for debt.

Under these rules, the AER is required to consider all the available inputs when setting the allowed rates of return for equity and debt. The rules continue to provide that gamma is a market valuation of the imputation credits that would be distributed by a benchmark firm.

In reviewing the draft determinations, UE is concerned that:

- The draft determinations proceed on the basis of an outdated assessment of the risks facing electricity distribution businesses in particular and this leads to a significant under-estimation of the required rate of return for equity.
- The AER is approaching the task of establishing an allowed rate of return on equity in a way that is so significantly misconceived that it cannot possibly result in a rate of return that is commensurate with the efficient costs of a benchmark firm, and nor does the method accord with the requirements of the rules.
- Although the central concept of introducing a trailing average for debt is a good one, there are a number of significant issues that need to be addressed in the way this would be implemented.

- For gamma, the AER's "conceptual approach" is simply not correct, and updating the data in the draft decisions to deliver a value of 0.4 instead of the number in the guideline (0.5) will not remedy the error.

Each of these issues is discussed further below under the following headings:

- Changing risk profile for electricity distribution network businesses
- Problems with the AER's Approach to Setting an Allowed Rate of Return for Equity
- The Business's Approach to the Allowed Return on Equity
- Implementing the Trailing Average Method for Debt
- An appropriate Transition Path for Debt
- Gamma

Please do not hesitate to contact me on (03) 88469854 if you require further information.

Kind Regards

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## Submission

### Changing risk profile for electricity distribution network businesses

The draft determinations proceed on the basis that conceptually a gearing ratio, a “beta” value within the SL-CAPM model, and a benchmark credit rating can adequately recompense the businesses for the returns required on risky investments and that a specific beta value of 0.7, and a credit rating of BBB+ are adequate for this purpose. The draft decisions, and the guidelines applied in those decisions, are largely based on a consideration of risk by the AER itself, and a report from Frontier Economics, both undertaken at the time of the AER’s WACC guideline process<sup>1</sup>.

It is simply not the case that an adequate compensation for risk can be provided in that way.

Firstly, the assessment by the AER and Frontier Economics that energy network businesses are less risky than the market portfolio as a whole fails to acknowledge the significant new risks arising from disruptive technologies such as solar power, battery storage, smart meters and the user-friendly service innovations that these technologies now enable. For the first time in a century, the combined effect of these developments is throwing into doubt the scale, design, direction for growth and longevity of electricity network investments.

The state of progress with respect to each of these disruptive technologies, and their potential effects, have been described in detail in a submission put before the AER by the ENA during the Rate of Return Guideline (WACC Guideline) process, and by SA Power Networks in its regulatory proposal<sup>2</sup>.

UE repeats those submissions in the context of the AER’s decision making processes listed in Appendix A.

The draft determinations suggest that in addition to recompensing a business for risk through the beta, the business is insulated from risk as there is a constrained ability for the regulator to remove assets from the regulatory asset base through “optimisation” assessments and that asset utilisation and cost recovery risks are recompensed through this form of protection for “cash flows”. The AER does not have a proper basis for concluding that these mechanisms are effective in controlling these risks particularly if the “death spiral” effect described in the SA Power Networks proposal were to occur.

Second, as is discussed in the next section of this submission, the SL-CAPM is acknowledged to produce downwardly biased returns for businesses with the characteristics of energy network businesses and part of the explanation for this is that other models are better at modelling and explaining how investors assess risk and seek for it to be compensated. Moreover, the model—like all models—is a simplification of reality. The assumptions underpinning it and the process for estimating its input parameters mean that it cannot be expected to reflect that reality perfectly, and in fact evidence suggests otherwise. This should put the AER and other users on notice to look for other evidence to support any return on equity estimate or to overcome identified limitations.

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<sup>1</sup> Frontier Economics, Assessing risk when determining the appropriate rate of return for regulated energy networks in Australia, A REPORT PREPARED FOR THE AER, July 2013

<sup>2</sup> SA Power Networks, Regulatory Proposal, 2015-2020, pages 306 to 309

## Problems with the AER's Approach to Setting an Allowed Rate of Return for Equity

A significant disagreement inherent in the different way in which the businesses and the AER approach the task of establishing an allowance for equity, concerns is the rule requirement that the AER considers the full range of relevant models and data available. The draft decisions proceed on the basis that it is sufficient to consider all the available material and then choose to accord some relevant inputs a very substantial weight, some a very constrained role and others no role at all. By contrast, the businesses consider that the rules should be interpreted in the same way the equivalent language was interpreted in the DBNGP case<sup>3</sup>. We are of the view that all the relevant information needs to be given a *real weight* that is proportionate to its probative merits. It is not acceptable to acknowledge that inputs are relevant and ascribe them no weight or to give such inputs a highly constrained role that does not reflect their probative value.

The AEMC's explanatory statement that accompanies the rules repeats a number of times that all the relevant material must be considered.<sup>4</sup> For example:<sup>5</sup>

*"Whether or not the estimated rate of return meets the allowed rate of return objective will invariably require some level of judgement, but this judgement should be based with reference to all relevant estimation methods, financial models, market data and other evidence that could reasonably be expected to inform a regulator's decision.*

...

*In addition, the regulator must make a judgement in the context of the overall objective as to the best method(s) and information sources to use, including what weight to give to the different methods and information in making the estimate."*

It would be a hollow exercise for the AEMC to have reformed the rules to permit a departure from the SL-CAPM, required an evaluation of all the available alternatives and then permit the decision maker to disregard models or inputs that are found to be relevant, and to essentially revert to the pre-existing approach.

The very concept of a "foundation model" and its implementation prevent, or improperly constrain, a proper assessment on the merits of how much real weight each input should be accorded.

Another similar error arises through the use of extra-legislative criteria<sup>6</sup> that impede a proper application of the allowed rate of return objective, the national electricity objective and the revenue and pricing principles directly to the models and other inputs. A number of these criteria are, on the surface, irrelevant, for example, whether the model is 'fit for purpose', i.e. whether it was originally developed for the purpose that it is now being put<sup>7</sup>, and whether the methodologies are "complex"<sup>8</sup>. Other criteria are

<sup>3</sup> Re: Michael AM; ex parte Epic Energy (WA) Nominees Pty Ltd & anor [2002] WASCA231 at paragraph 55.

<sup>4</sup> AEMC 2012, Economic Regulation of Network Service Providers, and Price and Revenue Regulation of Gas Services, Rule Determination, 29 November 2012, Sydney; pages i, iii, 26, 27, 30,31, and 48.

<sup>5</sup> Ibid., page 48.

<sup>6</sup> AER, Rate of Return Guideline Explanatory Statement, page 31.

<sup>7</sup> AER, Rate of Return Guideline Explanatory Statement, 17 December 2013, Page 31, Criterion 2(a)

applied in a way that improperly closes off a full consideration of the material (for example whether a model is “well accepted”<sup>9</sup>).

Neither the concept of a foundation model, and nor the criteria, are found in the National Electricity Law, (NEL), or the National Electricity Rules, (NER), and, in effect, these considerations amount to an improper recasting of the Rules.

Our second concern is that the AER’s assessment of the SL-CAPM appears to have been undertaken through “rose tinted glasses” whereby:

- There is an inadequate acknowledgement of the flaws of the SL-CAPM;<sup>10</sup>
- There is an inadequate recognition of the value that other models have in addressing flaws in the SL-CAPM;<sup>11</sup> and
- Inadequate weight is given to an empirical testing of the various models and empirical testing strongly favours models other than the SL-CAPM.<sup>12</sup>

Equally, the criticisms of other models are ill placed and excessively harsh:

- There is a suggestion that the Fama French three factor model is lacking because it arose from empirical observation rather than “theory” when in fact all theories are developed as a way to explain observed phenomena;
- Regardless of which came first – theory or empirical testing – the order does not affect the relevance of the model;<sup>13</sup> and
- There is a spurious distinction between a model’s ability to explain past equity returns as opposed to explaining future equity returns.<sup>14</sup> Unless there is a reason why the world has changed there is no basis for doubting the prospective usefulness of a model that very well explains past returns.

Ever since its adoption 40 years ago, the SL-CAPM has been acknowledged to have significant weaknesses but superior models were not widely available. Today a lot more is known about the weaknesses and why it is that the SL-CAPM performs poorly in empirical tests, while alternative asset

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<sup>8</sup> AER, Rate of Return Guideline Explanatory Statement, 17 December 2013, Page 31, Criterion 2(b)

<sup>9</sup> AER, Rate of Return Guideline Explanatory Statement, 17 December 2013, Page 31, Criterion 1(a)

<sup>10</sup> Compare SFG Consulting, The required return on equity for regulated gas and electricity network businesses, 6 June 2014, pages 8, 20 to 24 with AER, Rate of Return Guideline Explanatory Statement, Appendix A, pages 10 to 12.

<sup>11</sup> Compare SFG Consulting, The required return on equity for regulated gas and electricity network businesses 6 June 2014, pages 8, 26 to 40 with AER Rate of Return Guideline Explanatory Statement, Appendix A, pages 17

<sup>12</sup> Compare SFG Consulting, The required return on equity for regulated gas and electricity network businesses 6 June 2014, pages 8, 25, 35 with AER Rate of Return Guideline Explanatory Statement, Appendix A, pages 8, 11 to 12

<sup>13</sup> AER Rate of Return Guideline Explanatory Statement, 17 December 2013, Appendix A, page 8

<sup>14</sup> AER Rate of Return Guideline Explanatory Statement, 17 December 2013, Appendix A, pages 19 to 20

pricing models are widely available.<sup>15</sup> The SL-CAPM is a highly simplified model that takes a risk free rate and adds the product of a “beta” with a general market risk premium.

Over time, preferable asset pricing models have become widely accessible. The Black CAPM has a more flexible functional form and can more closely model observed returns and be used for predictions.<sup>16</sup> The Fama-French model has put forward additional variables that can have significant explanatory power when seeking to explain or predict market rates of return.<sup>17</sup>

Further, the previous approach of prescribing the use of a single asset pricing model precludes other ways of establishing fair returns, including methods that attack the task in a different way rather than seeking to value assets, such as the dividend growth model which were not given significant weight even though they have been employed for decades by energy regulators such as the Federal Energy Regulatory Commission in the United States:

*“The return on equity is derived from a range of equity returns developed using a Discounted Cash Flow (DCF) analysis of a proxy group of publicly held natural gas companies. The Commission currently uses a two-stage Discounted Cash Flow (DCF) methodology. The two-stage method projects different rates of growth in projected dividend cash flows for each of the two stages, one stage reflecting short term growth estimates and the other long term growth estimates. These estimates are then weighted, two-thirds for the short-term growth projection and one-third on the long-term growth, and utilized in determining a range of reasonable equity returns.”<sup>18</sup>*

However, the draft determinations make only minor adjustments to the approach that has existed since the advent of modern economic infrastructure regulation in Australia.

A significant part of the reasoning supporting the reselection of the SL-CAPM as a foundation model is explicitly conservative. Important factors in selecting this model included giving weight to the idea that other regulators adopt the SL-CAPM, or the AER’s perceptions as to whether the model is “well accepted”<sup>19</sup>. This is analogous to the rejection in the 1600s of Galileo Galilei’s submissions that an astronomical model in which the Earth revolves around the Sun better explains observed phenomena than the then “well accepted” Earth-centric model. If an existing model is shown to be flawed in ways that newer models are not, collective inertia is not a proper decision making constraint upon giving the newer model(s) real weight according to the substantive contributions that they can make. It cannot be the case that by removing any reference within the rules to the incumbency of the SL-CAPM, the AEMC intended a “chicken and egg” situation that prevents the regulator from moving to adopt a new model until another regulator has.<sup>20</sup>

<sup>15</sup> SFG Consulting, 6 June 2014, page 25, 35 and SFG Consulting 22 May 2014, Cost of equity in the Black Capital Asset Pricing Model 10 and 11

<sup>16</sup> SFG Consulting, The required return on equity for regulated gas and electricity network businesses 6 June 2014, page 8: “*The Black CAPM provides a better fit to the empirical data than the Sharpe-Lintner CAPM...*”

<sup>17</sup> SFG Consulting, The required return on equity for regulated gas and electricity network businesses 6 June 2014, page 8: “*The Fama-French model has the advantage of providing an unambiguously better fit to the data than the Sharpe-Lintner CAPM.*”

<sup>18</sup> FERC June 1999, Cost-of-Service Rates Manual for gas pipelines, page 16

<sup>19</sup> AER, Rate of Return Guideline Explanatory Statement, 17 December 2013, Page 31.

<sup>20</sup> AER, Rate of Return Guideline Explanatory Statement, 17 December 2013, Appendix A, pages 12 - 13

UE has devoted a substantial effort individually and through the Energy Networks Association to assemble a wealth of theoretical and empirical analysis to enable the AER to establish an allowed rate of return that integrates all the insights now available to finance theorists and market practitioners.<sup>21</sup> Many of these insights were not available when the SL-CAPM was first employed for economic regulation in Australia and the fact that past practice did not take them into account is not a basis today to exclude them. Indeed the preponderance of that evidence now available speaks very loudly of the need for change.

The above concerns with respect to a failure to recognise and respond to problems with the existing regulatory approach are even more acute when the draft decision determines to not even significantly reform the way in which the AER has implemented the SL-CAPM. In the current economic conditions, the AER's previous approach to specifying that model (i.e. by combining an immediate contemporaneous measure of the risk free rate with a market risk premium derived from more than 100 years' worth of data) delivers values that are necessarily materially lower than prevailing market returns.

Experts explain that there is no one-to-one relationship between movements in the risk free rate and the risk adjusted returns that investors require. In fact the market risk premium tends to fluctuate in the reverse direction from risk free rates.<sup>22</sup>

Although the expert work is informative at an aggregate level, there are also occasions when this concept is readily apparent to any intelligent observer. For example, shortly after the collapse of Lehman Brothers, two key propositions were inescapably prominent to finance market practitioners and the general business community alike – at the same time that investors became nervous and were demanding significantly increased returns, central banks were significantly reducing wholesale interest rates to try and stimulate economies. This is a stark example of what the expert evidence shows is generally the case: That the market risk premium and risk free rates can move in opposite directions, though not necessarily in a deterministic sense.

This means that adding a long run average market risk premium to an immediately observed risk free rate will deliver downwardly biased results when risk free rates are low and upwardly biased results when risk free rates are high. In the current environment of record low risk free rates, a simple addition of a very long term market risk premium with a contemporaneous risk free rate is almost bound to significantly under compensate equity investors.

Indeed, the approach in the draft determinations<sup>23</sup> delivers a nominal post tax return on equity of just 8.1% which is very substantially lower than the result for five years previously which provided for a return on equity of 11.82% in Ausgrid case, with similar figures for other businesses. More than two percentage points of that drop can be attributed to the fall in the underlying risk free rate. While the risk free rate has dropped in this way, there is simply no evidence available from which to conclude that equity investors' required rates have fallen in proportion to the fall in the risk free rate.

Most of the businesses that are the subject of the draft determinations are government owned and they do not have direct experience in dealing with market sourced equity investors but UE does have such experience. In our considered opinion, equity investors expect to receive considerably higher post tax

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<sup>21</sup> ENA, Response to the Draft Rate of Return Guideline of the Australian Energy Regulator 11 October 2013

<sup>22</sup> SFG Consulting, The required return on equity for regulated gas and electricity network businesses 6 June 2014, page 51 to 53

<sup>23</sup> AER, Draft Decision Ausgrid distribution determination 2015-16 to 2018-19, November 2014, Attachment 3, page 3-45



returns in the current economic environment than the 8.1% produced by the AER's modelling and we deny that the AER's approach produces an allowed rate of return that is commensurate with prevailing conditions.

It might be tempting to jump to the conclusion that under-compensating investors at this time is of little concern if, once the economic cycle turns, the current under-compensation could be offset by future over-compensation but this is not the case. If there is a mismatch in either direction between prevailing rates and regulatory allowances, then inefficiencies will arise. Firstly, there are costs for the businesses of absorbing inter-temporal fluctuations in returns through explicitly or implicitly carrying a balance sheet provision for such a mismatch. Secondly, at times of under-compensation timely investments are discouraged or delayed and at times of over-compensation the opposite effect applies and there is an incentive to invest earlier than required. Neither is efficient. Note also that these effects are pro-cyclical which means that the direction of the mismatch encourages businesses to reduce capital expenditures at times that input costs are likely to be low and to increase capital expenditures at times when input costs are likely to be high.

It is appropriate, therefore, that the rules require (as they do) that each determination provides for a regulatory allowance that is commensurate with the prevailing efficient costs for a benchmark firm at the time. In the AEMC's words:

"If the allowed rate of return is not determined with regard to the prevailing market conditions, it will either be above or below the return that is required by capital market investors at the time of the determination. The Commission was of the view that neither of these outcomes is efficient nor in the long term interest of energy consumers."<sup>25</sup>

In the current economic environment, this requires a significant change from the status quo.

## The Business's Approach to the Allowed Return on Equity

UE supports the approach in the SFG Consulting report<sup>26</sup> that gives real weight to:

- The rates of return predicted by the Black CAPM, Fama French and dividend growth models; and
- Both the Wright and Ibbotson approaches to estimating the market risk premium parameter for the SL-CAPM and other asset pricing models—thereby addressing the mis-match between contemporaneous risk free rates and a long run market risk premium.

The approach adopted by SFG Consulting, and the allowed rates of return that it calculates, constitute a modest, balanced, inclusive and responsible proposal that would deliver an allowed return on equity that is in line with current market conditions. The approach proposed does not opportunistically seize upon the model or particular inputs that deliver the highest returns, but instead accepts that all models should contribute to the resulting allowance – including the SL-CAPM even though it is known to be downwardly biased and delivers materially lower results than all the other available models, and could legitimately be characterised as an 'outlier'.

<sup>25</sup> AEMC Rule Determination, 29 November 2012, page 44

<sup>26</sup> SFG Consulting, The required return on equity for regulated gas and electricity network businesses 6 June 2014, pages 7 and 8



It is a great disappointment, therefore, that the draft determinations reject this approach and instead make only relatively minor adjustments to a “business as usual” approach that relies principally on a model that was “state of the art” more than 40 years ago for both the central focus of deriving a point estimate, and as a source of strict constraint on the use of other information. Indeed, the only material differences in approach by the AER in the draft determinations compared with the old rules is that the value of beta has been reduced to 0.7 and the value of gamma has increased to 0.4 and each of these changes is unrelated to the adoption of the new rules. The net effect at the end of the day is almost as if all the detailed work of interested parties contributing to the AEMC rule change process and WACC guideline had not occurred at all.

UE commends the SFG Consulting paper to you and requests that you reconsider and abandon the ‘foundation model’ approach in favour of an approach that gives real weight to all of the models that both the AER and SFG Consulting agree are the relevant models to consider.

In the current environment an allowed rate of return of approximately 10% (as established using SFG Consulting’s weightings) is appropriate and consistent with our views concerning the prevailing efficient costs of equity capital in our industry.

## Implementing the Trailing Average Method for Debt

UE supports the adoption of a regulatory framework that reflects the efficient costs of a benchmark entity. We agree with the AER<sup>27</sup> that under both the old rules and the new rules, efficient debt raising practices had to effectively manage refinancing risks and, therefore, efficient debt portfolios necessarily involve staggered maturities and that annual updating better reflects efficient practices. However, there are a number of ways in which we consider the approach to establishing the allowed rate of return for debt does not reflect the efficient costs of a benchmark firm.

The first consideration concerns the credit rating. In UE’s view, the benchmark credit rating should be a BBB credit rating based on the median credit rating of the businesses which do not benefit from the implicit support of significant Australian or foreign government equity.

The second consideration is that not all the efficient costs have been included in the AER’s proposed allowance. The AER draws its benchmarks from independent service providers which report on secondary market trades. However, businesses do not sell their debt in piecemeal quantities on secondary traded markets. Rather electricity network businesses must issue bonds in substantial tranches and CEG has established<sup>28</sup> that a new issue premium of approximately 30 basis points is paid by electricity network businesses.

Similarly, energy network businesses cannot manage cash flows on the unrealistic basis that incoming debt perfectly coincides with repayment obligations for expiring instruments. UE can only raise debt efficiently by holding a Standard & Poors (or equivalent) investment grade credit rating, and that agency requires that there is a buffer of time such that new debt is raised approximately three to six months prior to old debt expiring. During this over-lap period, we borrow at long term rates while the surplus can only earn the over-night interest rate. These costs are commonly referred to as the indirect costs of raising debt and they must be taken into account when setting an allowed rate of return.

<sup>27</sup> AER Rate of Return Guideline Explanatory Statement, 17 December 2013, Page 107

<sup>28</sup> CEG, The New Issue Premium, October 2014.

The AER has previously dismissed submissions for the inclusion of indirect costs associated with the use of the completion method to reducing refinancing risk, on the basis that the benchmark efficient firm would use the underwriting method of reducing refinancing risk, and the value of this method is already accounted for in the direct debt raising costs allowance based on the ACG methodology, which is already provided for in the AER's determinations<sup>29</sup>. The AER characterised this issue as one of 'double counting'.

However, Incenta has found that not only should the costs associated with the maintenance of liquidity reserve be considered direct costs, there is clearly no double counting issue.

".. since the fees that are incorporated into the estimates of the transaction costs (which stem from a method recommended in an ACG report from 2004) made it clear that while the label 'underwriting costs' was commonly used for the fees in question, that label was a misnomer. Rather, those fees were actually paid to investment banks for arranging the transaction (a service), and there was in fact no risk taking (and underwriting) by the bank in question."<sup>30</sup>

In the draft NSW determinations<sup>31</sup>, the AER appears to have rejected arguments in favour of the inclusion of completion method costs on an alternative basis to the reasons adopted in the earlier South Australia Distribution Determination. The AER has stated that:

*"the PTRM's timing assumptions already provide adequate compensation for the timing of revenue compared to the expenses, to the extent that these cost streams are necessary"*<sup>32</sup>

In principle, each of the PTRM and the WACC should be determined on an accurate basis. This issue warrants further examination to determine whether it is in fact the case that the PTRM timing assumption does provide a timing benefit to the businesses and if so, whether this is sufficient to offset other costs and indeed whether an offset between the PTRM and the WACC calculations is the most appropriate method to address these issues.

To the extent that UE's operational expenditure or capital expenditure allowances do not make provision for the direct costs of raising debt (i.e. underwriters fees, legal fees and the like), then these also need to be included in the WACC calculation.

The third consideration concerns the source of the market data for debt. In the draft determinations, the AER proposes to source the figures as a simple average of the figures available from Bloomberg and from the RBA (each extrapolated out to the 10 year benchmark tenor). In reaching this decision, the AER sought to follow the approach that the Australian Competition Tribunal requires but in our view this was not done properly.

The Australian Competition Tribunal requires<sup>33</sup> that the AER consider for each of the available services:

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<sup>29</sup> AER, *Final Decision, SA Distribution Determination 2010-11 to 2014-15* (ETSA Utilities), p. 384.

<sup>30</sup> Incenta (2014) *Debt raising transaction costs – Ausgrid*, May 2014, p. 2.

<sup>31</sup> See AER, *Draft Decision, Jemena Gas Networks (NSW) – Access Arrangement 2015-20*, Attachment 3 Rate of return, p. 3-311.

<sup>32</sup> *Ibid*, p. 3-313.

<sup>33</sup> *ActewAGL Distribution [2010] ACompT 5; (2010) ATPR 42-324*, paragraph 77

- Its approach to bond selection and curve specification.
- The past performance of the service.
- Whether the figures published by the service reflect the prevailing market trade at the time the assessment is made.

In all the draft determinations, the AER undertook the first two of these assessments and in the Jemena Gas Networks draft determination shunned the third, characterising it as an “indirect” and inferior means of assessing which is a better service compared with the first which it described as a “direct” and superior basis for assessing which of the services better merits selection.<sup>34</sup>

UE does not agree that the draft decisions adequately test the merits of the two services because there is no assessment as to which of the services better reflects the prevailing market trade. Further, to characterise a comparison of the figures published to underlying trades as an “indirect” assessment indicates that the AER has mistaken the task before it. The rate of return objective requires that the allowance for debt is commensurate with the prevailing costs of a benchmark firm, and a comparison between the figures produced by the independent service provider and the underlying market trades, (or the best proxies for such trades), is the most direct way to bring about an allowance that is commensurate.

Since the AER has determined that there should be annual updating of the benchmark debt data itself, it stands to reason that there also needs to be an updated selection of which service to use. There is no legal impediment to doing this because it can be an automated and formulaic process as proposed by Jemena Gas Networks.

## **An appropriate Transition Path for Debt**

Rule 6.5.2(j) provides that the allowance for debt may be determined using the “on the day” method, on the basis of an average of the costs of debt raised over a historical period prior to the determination or a combination of the two. Rule 6.5.2(k) provides that the allowance would take account of any impacts on the benchmark efficient firm arising from a change in methodology.

UE is aware and understands why from the NSW electricity businesses’ perspective they would consider that a transition is unnecessary for their businesses given that they have already effectively adopted a trailing average even before the new rules came into effect. We have a somewhat different perspective on this issue but we too have concerns that the AER’s proposed approach does not meet the rate of return objective.

- Under the previous regulatory arrangements, an efficient benchmark business needed to manage as best as it could:
  - Refinancing risk (i.e. the risk that it may not be possible or economic to refinance a business’s entire debt portfolio at one time or a substantial part of it); and
  - The risk of disparities in interest rates between the averaging period used for the “on the day” methodology and the interest rates prevailing at the time debt was actually raised.

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<sup>34</sup> AER, Draft decision, Jemena Gas Networks (NSW) Ltd, Access arrangement 2015–20, Attachment 3, November 2014, page 3-215

In 2009, as part of consultation on the AER's WACC parameter reset determination, the corporate treasurers of Envestra (paragraphs 5.16, 5.17, 6.4 and 6.5),<sup>35</sup> Jemena (see paragraph 5.19, 5.23 and 5.25),<sup>36</sup> SP Ausnet (paragraphs 4.9 to 4.15 and 5.1 to 5.9)<sup>37</sup> and Citipower and Powercor (paragraphs 5.2, 5.4, 7.1 and 7.2)<sup>38</sup> each provided the AER with statements explaining how under the previous rules no business would prudently raise all its debt in the "on-the-day" averaging period. Rather all businesses sought to stagger their maturities to avoid refinancing risk and then generally undertook hedging transactions to control their exposures to interest rate movements as well as they reasonably could.

Although there is an actively traded market for swaps, there is no equivalent for generic BBB debt and therefore it is not possible to hedge movements in the debt risk premium. Indeed an ability to better manage volatility in the debt risk premium is one of the principal advantages of ultimately moving to the trailing average method. This has been acknowledged by the AER:<sup>39</sup>

*"For an Australian efficient operator there is no market to effectively, and in a cost efficient manner, hedge their DRP."*

The AER has acknowledged that this is how an efficient benchmark firm would have managed its debt portfolio at that time:<sup>40</sup>

*"Given the observed practices of regulated network businesses and the definition of the benchmark efficient entity, we consider that the following practice is likely to constitute **an efficient debt financing practice of the benchmark efficient entity** under the current 'on the day' approach:*

- *holding a debt portfolio with staggered maturity dates and using swap transactions to hedge interest rate exposure for the duration of a regulatory control period..."*

The above finding was restated in the draft Ausgrid determination<sup>41</sup>.

Under the previous rules, the "on-the-day" methodology was mandatory and the flexibility concerning whether and how the AER might recompense the businesses for their efficient costs was constrained.

- Under the new rules, however, the AER has greater flexibility in setting the returns on debt. However:
  - It is mandatory under rule 6.5.2(a) and (b) to determine the debt allowance consistent with the rate of return objective which requires that the rate of return be commensurate with the efficient financing costs of the benchmark efficient entity; and

<sup>35</sup> Statement of Gregory Meredith (Envestra), an appendix to the Joint Industry Associations' submission to the AER on the WACC parameters review of February 2009

<sup>36</sup> Statement of Sim Buck Khim (Jemena), an appendix to the Joint Industry Associations' submission to the AER on the WACC parameters review of February 2009

<sup>37</sup> Statement of Alastair Watson (SP AusNet), an appendix to the Joint Industry Associations' submission to the AER on the WACC parameters review of February 2009

<sup>38</sup> Statement of Andrew Noble (Citipower and Powercor), an appendix to the Joint Industry Associations' submission to the AER on the WACC parameters review of February 2009

<sup>39</sup> AER, Better Regulation, Explanatory Statement, Rate of Return guideline, page 122.

<sup>40</sup> AER, Better Regulation, Explanatory Statement, Rate of Return guideline, page 107.

<sup>41</sup> Page 3-115.

- Where there is discretion to be exercised that it be done in accordance with the revenue and pricing principles of the NEL including providing network businesses with a reasonable opportunity to recover its efficient costs.

Having made the factual finding that it is efficient under the previous rules for a business to raise debt on a staggered basis and to hedge to the averaging period, it would be an error not to establish the rate of return on a basis that enables the businesses to recover the efficient (transaction and other) costs of doing so.

The transition path in the guidelines is not established on that basis and it is at significant risk of failing to comply with the rule 6.5.2(a) and the section 7A of the NEL unless it can be demonstrated that the transition path in the guideline provides *at least* as high a return as a transition path that is explicitly calculated on the basis of the costs of a business with a portfolio of debt with staggered maturities and hedging.

It would be considerably safer for the AER to make a determination that directly employs its finding concerning the efficient debt portfolio of a benchmark efficient business and for that reason this proposal establishes its costs on the basis set out above.

This means that the benchmark efficient firm would transition into the first determination under the new rules with:

- A trailing average DRP; and
- A floating rate exposure for its underlying or risk free component of its cost of debt (which it can hedge).

Therefore in making its draft and final decisions for UE, the AER should not adopt the Guideline position on transitional arrangements for the return on debt. Rather, the AER should adopt a position that is consistent with the new analysis it has undertaken and the expert advice that it has received on this issue.

In light of the AER's findings in the NSW Draft Decisions, a 'hybrid' transitional arrangement would be more appropriate. That is:

- There should be a ten-year transition to a trailing average estimation of the risk-free rate component of the return on debt; and
- There should be no transition for the debt margin (or debt risk premium) component. That is, the AER should immediately move to a trailing average estimation of the debt risk premium component. This means that for the first year of the forthcoming regulatory period, the debt risk premium would be estimated as a ten-year trailing average, and this trailing average estimate would be updated in each subsequent year.
- This approach would provide for an estimate of the return on debt which better reflects the required return on debt for the benchmark efficient entity. As noted above, under the efficient financing strategy identified by the AER in the NSW Draft Decisions, the base interest rate component of the benchmark efficient entity's actual return on debt would have been matched with the regulatory allowance set using an "on-the-day" rate, but the debt risk premium component each year would have reflected the historical (or trailing) average of the debt risk premiums over the previous ten years.

Accordingly, UE submits that the AER should not adopt the Guideline position on transitional arrangements for the return on debt. Rather, the AER should adopt the hybrid transitional arrangement described above.

## Gamma

Notwithstanding the detailed material set out in the draft determinations, UE considers that a correct and internally consistent regulatory determination requires that the gamma be established based on a true market valuation as are all the other WACC parameters.

Although gamma is an input into the corporate income tax calculation, the value adopted for gamma ultimately has a role determining returns for equity-holders. If the value ascribed to imputation credits is higher than the value that equity-holders place on them, the overall return to equity-holders will be less than what is required to promote efficient investment in, and efficient operation and use of, energy network services for the long term interests of consumers.

A secondary reason why gamma needs to be established as a market value concerns internal consistency. If a market valuation for gamma is not adopted, the market valuations of other WACC parameters would not make sense where the valuations rely on investors' market valuations for gamma.

While it is interesting to consider the original writings by Officer, there are limitations to the usefulness of doing this. While his work clearly recognised the fundamental point – the need for imputation credits to be considered – a lot of much more detailed work has subsequently been done to explore fully how the concept should be implemented in practice.

The draft determination acknowledges that there are apparent ambiguities in the way in which Officer's original documents described gamma because reference was made to both "value of a dollar of tax credit to the shareholder" and to the "proportion of the tax collected from the company [to] be rebated against personal tax".

On page 4-34, Handley is quoted as asserting that these two terms were used interchangeably, with the "proportion of tax" concept being what Officer intended but this is unconvincing. It would seem more likely that Officer had in mind a valuation concept but had not researched the issue of why the market valuation might diverge significantly from the redemption value and for that reason he used the terms interchangeably.

In any event, when looking at the broader picture in which energy network businesses need to compete in equity markets to attract investment capital, it is a market valuation which is relevant.

Neither the 'equity ownership approach' developed by the AER nor an examination of tax statistics concerning the nominal dollar amounts are suitable for establishing a market valuation. In UE's view, neither the equity ownership approach nor the tax statistics approach are relevant (except in as much as tax statistics provide an upper bound on the value of gamma because it is highly unlikely that the market valuation could ever materially exceed the nominal value of the credits).

SFG Consulting<sup>42</sup> provides the most comprehensive and up to date analysis using market valuation methodologies and a number of criticisms have been levelled at this work in the draft determinations. SFG Consulting has responded to those criticisms in full.

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<sup>42</sup> SFG Consulting, An appropriate regulatory estimate of gamma, prepared for Jemena Gas Networks, May 2014.



Based on the SFG Consulting work, UE considers that 0.25 is the most appropriate market valuation of gamma.



## **Appendix A: Australian Energy Regulator Draft Determinations**

ActewAGL, 27 November 2014

AusGrid, 27 November 2014

Directlink, 27 November 2014

Endevour Energy, 27 November 2014

Essential Energy, 27 November 2014

Jemena Gas Networks (NSW), 27 November 2014

TasNetworks, transmission determination, , 27 November 2014

TransGrid, 27 November 2014