

Revised Final Plan Attachment 10.9

Response to Draft Decision: Financing Costs

August 2017

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1. Response to Draft Decision on Financing Costs

1.1 Introduction

This attachment sets out Australian Gas Networks Limited's (AGN's) response to the Australian Energy Regulator's (AER's) Draft Decision on forecasting financing and tax costs over the next (2018 to 2022) Access Arrangement (AA) period. The AER's Draft Decision was to apply its preferred approach when determining financing and tax costs for AGN over the next AA period, which approach is consistent with our Final Plan.

Our single largest cost relates to the cost of financing our \$1.6 billion investment in our Victorian and Albury natural gas distribution networks (the networks). Achieving a reasonable rate of return that meets the objectives of the National Gas Rules (NGR) is essential in order to attract the necessary funding from shareholders (through equity) and debt providers to continue to invest in our networks.

The importance of financing and tax costs has meant that these issues have been highly contentious, resulting in several legal reviews. Since our submission of the Final Plan in December, the Full Federal Court has published its decision in relation to the New South Wales (NSW) Electricity and Gas businesses. Despite these decisions there continues to be uncertainty as how to properly determine financing and tax costs under the NGR. These matters are unlikely to be resolved until the AER remakes its decisions for those NSW businesses as directed by the Full Federal Court.

Given the ongoing uncertainty, and consistent with the approach taken in our Final Plan that was supported by stakeholders, we have continued to apply the AER's preferred approach in our Revised Final Plan.

1.2 Stakeholder Engagement

In preparing this Revised Final Plan we have continued to engage with stakeholders, including our Reference Groups and through the submissions to the AER on our Final Plan.

There were five stakeholder submissions that commented on the forecast financing and tax costs proposed in our Final Plan (see Table 1.1).

Our Revised Final Plan was presented to our Retailer Reference Group and Victorian and Albury Reference Groups in July, noting that we have continued to apply the AER's approach for estimating financing costs. We acknowledged the continued uncertainty surrounding certain rate of return parameters and explained our preferred approach to address these issues through the AER's upcoming Rate of Return Guideline review.

Table 1.1: Consideration of Stakeholder Feedback on Tax and Financing Costs

| Stakeholder Feedback on the Final Plan | Our Response to Feedback on the Final Plan |
|---|--|
| <p>Stakeholders, including the Consumer Challenge Panel 11 (CCP11) ¹, Red Energy and Lumo Energy², and Origin Energy³, were supportive of our adoption of the AER's preferred approach to determining the rate of return.</p> | <p>Consistent with our approach in our Final Plan and the expectations of stakeholders, we have continued to apply the AER's preferred approach to determining the rate of return given the uncertainty arising from current legal activity.</p> |
| <p>Uniting Communities in its submission on our Final Plan acknowledged that the rate of return parameters and gamma are under legal reviews, and that industry as well as stakeholders will need to accept the outcomes of the legal reviews. Uniting Communities did go onto state that its submissions to those legal reviews have advocated for a gamma of 0.5, which gamma differs from that currently applied by the AER 0.4⁴.</p> | <p>As with the rate of return, given the uncertainty arising from current legal activity, we have continued to apply the AER's preferred approach to estimate gamma of 0.4.</p> |

Note: In this 'traffic light' table, green shading represents no change from the Final Plan, orange represents a modification of the position outlined in the Final Plan and red shading represents a change from the Final Plan.

1.3 AER Draft Decision

The AER approved our application of its preferred approach to determining the return on equity and return on debt, and consequentially the rate of return for the next AA period.

The AER also approved our application of its preferred approach to determining tax costs. The estimate of tax costs are based on an assessment of our taxable income, the applicable corporate tax rate and the value of imputation credits (or gamma) to equity holders. The AER approved our application of the AER's preferred value for gamma of 0.4.

Table 1.2 provides a summary of the AER Draft Decision on financing and tax costs.

¹ CCP11, *Response to proposals from AGN, AusNet and Multinet for a revenue reset/access arrangement for the period 2018 to 2022*, page 72, 3 March 2017.

² Red Energy and Lumo Energy, *Australian Gas Networks Access Arrangement*, page 3, 6 March 2017.

³ Origin Energy, *Victorian Gas Access Arrangement Review – 2018-22 Response to Gas Distribution Business' Proposals*, page 4, 17 February 2017.

⁴ Uniting Communities, *Australian Gas Networks Access Arrangement Proposal for Victoria / Albury*, page 9, 19 April 2017.

Table 1.2: Summary of AER's Draft Decision on Tax and Financing Costs

| | AER Draft Decision | AGN Comment |
|-----------------------------|--------------------|---|
| Financing Costs | | |
| Risk free rate | Accept | As per the AER's preferred approach. |
| Equity beta | Accept | As per the AER's preferred approach. |
| Market Risk Premium | Accept | As per the AER's preferred approach. |
| Return on Equity | Accept | As per the AER's preferred approach. |
| Return on Debt | Accept | As per the AER's preferred transition approach to the trailing average. |
| Gearing | Accept | As per the AER's preferred approach. |
| Rate of Return | Accept | As per the AER's preferred approach. |
| Tax Costs | | |
| Value of Imputation Credits | Accept | As per the AER's preferred approach. |
| Tax Asset Base | Modify | Update for more recent capex information. |

Note: In this 'traffic light' table, green shading represents the AER's acceptance of AGN's Final Plan, orange represents the AER's modification of AGN's Final Plan and red shading represents the AER's rejection of AGN's Final Plan.

1.4 AGN Response to the Draft Decision

We have accepted the AER's Draft Decision on financing and tax costs (see Table 1.3).

Table 1.3: Summary of AGN's Response to the AER's Draft Decision on Financing and Tax Costs

| | AER Draft Decision | AGN Response | AGN Comment |
|-----------------------------|--------------------|--------------|--|
| Financing Costs | | | |
| Risk free rate | Accept | Accept | The risk free rate will be updated by the AER at the time of their Final Decision. |
| Equity beta | Accept | Accept | As per the preferred AER approach. |
| Market Risk Premium | Accept | Accept | As per the preferred AER approach. |
| Return on Equity | Accept | Accept | The return on equity will be updated in line with the update to the risk free rate at the time of the AER's Final Decision. |
| Return on Debt | Accept | Accept | We will continue to apply the AER's preferred approach to determining the return on debt until uncertainty is resolved. As with the return on equity, the return on debt value will be updated at the time of the AER's Final Decision. |
| Gearing | Accept | Accept | As per the preferred AER approach. |
| Rate of Return | Accept | Accept | The rate of return will be updated in line with the updates to the return on equity and return on debt at the time of the AER's Final Decision. |
| Tax Costs | | | |
| Value of Imputation Credits | Accept | Accept | As per the AER's preferred approach. |
| Tax Asset Base | Modify | Accept | We have accepted the AER's Draft Decision in respect of the tax asset base. We have updated the tax asset base in this Revised Final Plan for more recent capex information consistent with those updates made to the capital base (refer Attachment 9.6). |

Note: In this 'traffic light' table, green shading represents the acceptance, orange represents a modification and red shading represents a rejection.

1.5 Summary

Over the next AA period AGN will apply the AER's preferred approach to determine financing and tax costs. Financing costs will be updated just prior to the Final Decision, and through the next AA period for the cost of debt, as per the AER's preferred approach. Table 1.4 provides a summary of

the indicative rate of return and gamma parameters that have been included in this Revised Final Plan.

Table 1.4: Indicative AER Rate of Return and Gamma

| Parameters | AGN Revised Plan |
|-------------------------------|------------------|
| Return on Equity | 7.00% |
| Risk Free Rate | 2.45% |
| Equity Beta | 0.7 |
| Market Risk Premium | 6.50% |
| Return on Debt | 4.65% |
| Overall Rate of Return | 5.59% |
| Gamma | 0.4 |

Table 1.5 provides the Revised Final Plan tax asset base, including the opening tax asset base value as at 1 January 2018 of \$710 million (\$nominal).

Table 1.5: Roll Forward of the Tax Asset Base 2018 to 2022 (\$nominal, million)

| | 2018 | 2019 | 2020 | 2021 | 2022 |
|------------------------------|--------------|--------------|--------------|----------------|----------------|
| Opening Tax Asset Base | 709.9 | 800.1 | 904.9 | 995.3 | 1,055.6 |
| <i>Plus</i> Gross Capex | 119.6 | 140.8 | 136.9 | 115.5 | 84.7 |
| <i>Less</i> Tax Depreciation | 29.3 | 36.0 | 46.4 | 55.2 | 58.4 |
| Closing Value | 800.1 | 904.9 | 995.3 | 1,055.6 | 1,081.9 |

Note: Totals may not add due to rounding.