ActewAGL for you

21 June 2013

Mr Warwick Anderson
General Manager Network Regulation Branch
Australian Energy Regulator
GPO Box 3131
Canberra ACT 2601

Dear Mr Anderson

Response to Rate of Return guidelines consultation paper

ActewAGL Distribution (ActewAGL) welcomes the opportunity to provide this submission in response to the AER's consultation paper on the Rate of return guidelines.

ActewAGL Distribution is a member of the Energy Networks Association (ENA) and has contributed to and supports the ENA's comprehensive submission to be provided in response to the Consultation paper. In addition to the matters raised in the ENA's submission, ActewAGL would like to note following.

Return on Equity

ActewAGL supports the ENA's multi-model approach to the cost of equity and considers that the proposed framework to distil a final cost of equity estimate would, where applied correctly, be consistent with the allowed rate of return objective. The multi-model approach will likely also support a more stable rate of return on equity over time in the interests of both consumers and investors.

As noted by the AER, there is no 'perfect' cost of equity model.[1] ActewAGL is concerned that the use of one primary model, even with reasonableness cross checks, would not be as objective as a multi-model approach, relying instead largely on the AER's judgement as to what constitutes a "not reasonable" output from the primary model. This would leave a wide band of outcomes that effectively use only a single model and so undermines many of the benefits of the multi-model approach, including stability of the estimate and the full use of a wide range of relevant financial models and evidence.

ActewAGL considers that the use of a multi-model approach with a transparent framework that considers a broader range of information would generate return on equity outcomes that are more accurate and more consistent with the rate of return objective than any single model could.

The AER has stated that "the adoption of, a stable regulatory return on equity would at times arguably produce an estimate that would not reflect prevailing estimates". ActewAGL disagrees with the implication that 'stability' was to be pursued for its own sake, and considers instead that the 'true' cost of equity is far more stable over time than the AER's previous modelling approach (an implementation of the CAPM) suggests.

As discussed in ActewAGL's submission in response to the AER's Issues Paper, if there is an option to choose between two modelling approaches that both result in a rate of return consistent with the rate of return objective, ActewAGL's preference is to chose the model/method that generates more stable outcomes over time.

Term to Maturity

In regards to the appropriate term of maturity for the cost of debt, ActewAGL supports a long-term horizon, consistent with the long-lived nature of regulated assets as generally employed in prudent asset-liability

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[1] AER 2013 Rate of Return Guidelines Consultation Paper, May 2013, p42

management and in the AER's previous approach to the cost of debt. Matching the term to the length of the regulatory period is poor regulatory practice which distorts efficient market outcomes and can induce inefficient financing costs and risks.

ActewAGL does not consider it feasible to accurately estimate a term structure for equity returns, though in principle the term would match that for debt – that is, a ten year maturity, consistent with the long lives of the assets and the business as an ongoing concern.

Inflation

ActewAGL supports the AER's current method for forecasting inflation. The method relies on the fact that the RBA has strong influence on the inflation rate through the setting of monetary policy. The result is more stable and predictable over time than that delivered by the Fisher equation which in June 2008 indicated that inflation would be above 4% on average over the next 10 years—outside of the RBA's objective range—and only seven months later that it would be only 1.5% over the next ten years.

Cost of Debt

ActewAGL supports the trailing average portfolio approach to the cost of debt. ActewAGL considers that for consistency the Guidelines should outline all of the three approaches specified in the Rules.

ActewAGL also notes that it considers the portfolio approach to be appropriate for smaller businesses, which must still seek to mitigate refinancing risk. However smaller NSPs may not be able to issue debt at the same terms as a larger business as the debt issuances would need to either be substantially smaller or be issued more infrequently.

Where a small utility is not adequately compensated with the appropriate cost of debt or through higher debt raising costs, the cost is ultimately borne by equity holders. This may mean that inclusion of a size factor in the cost of equity is required.

Debt Raising Costs

The AER stated in its consultation paper in relation to debt raising costs that "these costs are small" and that "allowances of such level would not pass the threshold for consideration under our pass-through arrangements."[2] ActewAGL considers that, over time, debt raising costs may still form a material part of the costs to the regulated firm (especially for a smaller business). It therefore seeks confirmation from the AER that its preference for avoiding a specific allowance will not lead to an ongoing failure to compensate for the efficient cost of business operations. It needs to be demonstrated how the AER will ensure proper compensation for these costs if they are not defined under either the operating or capital cost building blocks. For a smaller provider, debt raising costs are likely to be a larger proportion of the total cost of debt.

The AER noted that "a smaller service provider might not be able to efficiently issue debt at frequent intervals (as assumed by portfolio approaches)."[3] ActewAGL considers that a portfolio approach remains appropriate for its business, as even small utilities seek to mitigate refinancing risk. While the benchmark cost of debt should be reproducible and achievable, the regulated business may decide against reproducing it exactly.

Other Issues

Datasets to use

In response to AER's consultation Question G.4

[2] p63
[3] p50

Should we develop our own dataset for estimating the return on debt or use a third-party source such as Bloomberg? What would be the key considerations in developing our own dataset and how should they be addressed?

ActewAGL notes that, should the AER opt to develop its own dataset, the AER would need in the interests of transparency and accountability to continually publish the bond indices that would be used in determinations, along with the source data and methodology used to derive the index.

The data demands of this approach would likely be considerable, and would likely include a range of bonds centred on the benchmark value. The method to construct the index should not be a simple average as per ERAWA's method, but should adjust for an asymmetric sample around the target tenor, nonlinearities in the yield curve and differing coupon rates across different bonds, while maintaining financial relationships such as no-arbitrage.

Systematic Risk

ActewAGL considers that there may be multiple dimensions to systematic risk, not simply 'beta–correlation' with the broad market. Alternative cost of equity models to the SL-CAPM account for these by including separate risk factors that investors require compensation for. Some international regulators have recognised that the CAPM does not capture all of the relevant forms of risk that the rate of return should compensate the business for, for example recent decisions in the UK have included a small company premium for certain utilities.[4]

Differences in beta between gas and electricity

In its response to the Issues Paper in February 2013, ActewAGL supported the AER investigating whether there is a difference in the relevant risk profile between gas and electricity distribution businesses. ActewAGL continues to support this.

In its guideline paper, the AER indicated that it was considering broadening the sample of relevant firms for statistical estimation to include water and wastewater utilities. While ActewAGL appreciates there are data problems when performing statistical estimation of relevant cost of capital parameters (for example, beta and the DRP), broadening the sample to include different types of utilities also introduces the risk of misinterpreting the true risks of different business activities.

ActewAGL is keen to participate in the AER's Rate of Return Guideline process. Should you wish to discuss in detail any of the matters raised above, please contact Mr Chris Bell, Manager Regulatory Affairs, on (02) 6248 3180.

Yours sincerely

David Graham
Director Regulatory Affairs and Pricing

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[4] For example, Ofwat's PR09 included a premium of 0.1-0.4% for certain utilities.