

12 May 2016

Mr Warwick Anderson
General Manager
Network Regulation
Australian Energy Regulator
23 Marcus Clarke Street
Canberra ACT 2601

Dear Mr Anderson

Implications of recent Tribunal decisions for final decision and updates to the allowed rate of return and forecast inflation estimates

Our revised access arrangement proposal for the 2016-21 access arrangement period of January 2016 (**Revised AAP**) noted events subsequent to our Revised AAP that would have the potential to impact on our allowed rate of return proposal. Those noted were:

- the decisions of the Australian Competition Tribunal (**Tribunal**) in respect of the 2015 decisions of the Australian Energy Regulator (**AER**) regarding the Networks NSW (**NNSW**) distributors, ActewAGL Distribution and Jemena Gas Networks (**JGN**) (**Tribunal's Determinations**); and
- updated estimates of the return on debt and return on equity by reference to our actual averaging periods.

In accordance with the indication in our Revised AAP that we would do so, we now:

- outline our understanding of the implications of the Tribunal's Determinations for the AER's impending final decision in respect of ActewAGL Distribution's 1 July 2016 to 20 June 2021 access arrangement for the ACT, Queanbeyan and Palerang gas distribution network (**Final Decision**); and
- update our estimates of the return on debt and return on equity, together with the resulting overall allowed rate of return, by reference to our actual averaging periods.

We also update our forecast inflation for our actual averaging period for the risk free rate used to estimate the return on equity.

Implications of the Tribunal's Determinations for the Final Decision

The implications of the Tribunal's Determinations for the Final Decision are detailed in **Attachment 1**. While we appreciate that the AER filed judicial review applications in respect of the Tribunal's Determinations on 24 March 2016 (**AER's JR Applications**), unless and until the Full Federal Court sets aside the Tribunal's Determinations and an alternative decision is made, the only reasonably open course for the AER for the purposes of the Final Decision is to apply the reasoning in the Tribunal's Determinations.

By way of summary, applying the Tribunal's reasoning to ActewAGL Distribution requires the AER to:

- estimate the return on debt using the trailing average approach to estimating the return on debt, without any transition, as proposed; and
- adopt our proposed value for gamma of 0.25.

The Tribunal did not comment specifically on the curve selection methodology proposed by JGN, rather, it held that the AER's reasons for adopting the simple average of the Reserve Bank of Australia (RBA) and Bloomberg curves in estimating the return on debt were cogent and reasonable.

We maintain the position outlined in our Revised AAP that, in estimating the cost of debt for 2016/17 and subsequent regulatory years, all available independent data sources and the average of these data sources should be tested to determine the data source and extrapolation method that best fits a representative sample of bond yields over the relevant averaging period. If, however, the AER maintains its position as outlined in the draft decision of 26 November 2015 in respect of our 2016-21 access arrangement (**Draft Decision**) that an average of available data sources should be used for the purposes estimating the cost of debt in those years, we consider that the curve published by Reuters should also be included in the average.

Updated allowed rate of return and forecast inflation estimates

Rate of return estimates updated to reflect our actual averaging periods, which have now passed, are described in **Attachment 2**.

The updated return on debt estimates have been calculated by Competition Economists Group (CEG). CEG's workings are set out and explained in the confidential spreadsheet and Memorandum dated 11 May 2016, which are provided as **Attachments 3 and 4**.

Attachment 2 also includes our inflation forecast updated for our actual averaging period for the risk free rate. Consistent with CEG's prior advice,¹ it is necessary to update the inflation forecast now that that averaging period has passed. This is particularly so given that market inflation expectations have fallen materially in the period elapsing between the submission of our Revised AAP and our averaging period, with actual inflation data (released after our Revised AAP was submitted) being very low in the December 2015 quarter (1.5 per cent annualised) and negative in the March 2016 quarter (-0.7 per cent annualised).

These calculations are set out in the report titled '*Update to nominal risk free rate and expected inflation*' of May 2016, provided as **Attachment 5**.

Confidentiality claims

We claim confidentiality over the Bloomberg and Reuters data included in CEG's confidential spreadsheet used to calculate the return on debt as strategic information (Attachment 3). ActewAGL Distribution does not own the copyright in the data under its contract with the suppliers and disclosure of the data could result in compensation claims and loss of the ability to source the data in future for ActewAGL Distribution. Third parties can source this data through the suppliers.

¹ Updating the inflation forecast is consistent with CEG's prior advice that the inflation forecast that is paired with the cost of equity should be measured in the same averaging period as the risk-free rate / cost of equity.

If you have any queries regarding the above or the Attachments, please contact ActewAGL Distribution's manager of gas regulation, Philip Deamer (philip.deamer@actewagl.com.au or (02) 6248 3438).

Yours sincerely



Michael Costello
Chief Executive Officer
ActewAGL

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- Attachment 1 - Implications of Tribunal Decisions For ActewAGL Distribution, May 2016
- Attachment 2 - Updated Rate of Return And Forecast Inflation Values, May 2016
- Attachment 3 - CEG, Updated estimation of proposed return on debt (confidential version only)
- Attachment 4 - CEG, *Memorandum: Cost of debt calculations*, 11 May 2016
- Attachment 5 - CEG, *Update to nominal risk free rate and expected inflation*, May 2016
- Attachment 6 - Materials referred to in Attachments 1 and 5

