11 October 2013

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

Dear Mr Anderson

Response to Draft rate of return guideline

ActewAGL Distribution (ActewAGL) welcomes the opportunity to contribute on the AER's Draft Rate of Return Guideline (the draft guideline), and looks forward to further consultation with the AER during its development of the final guidelines.

ActewAGL is a member of the Electricity Networks Association (ENA) and has contributed to and supports the ENA's submission on the draft guideline. Generally, ActewAGL considers that the ENA's multi-model approach makes better use of the range of models and information available to estimate the cost of equity and would support that the ENA's multi-model approach be adopted in the final guideline. In this submission ActewAGL restricts its comments to how the AER's foundation model could be improved through simple changes to incorporate model and empirical evidence omitted from, or given an unduly limited role in, the draft guideline.

ActewAGL is among the first DNSPs that will be subject to a determination under the new Guidelines along with the NSW DNSPs. ActewAGL strongly recommends that the AER include a fully worked example of the determined approach in the explanatory statement to the final guidelines. This will reduce ambiguity in regards to how the AER intends to apply the guideline.

ActewAGL notes that the NSW Independent Pricing and Regulatory Tribunal (IPART) included an estimate of its own WACC methodology in the Draft Report, comparing outcomes which that Report's methodology would produce with IPART's most recent water utility decisions. The IPART also signalled that it intended to publish biannual updates of where it considered the WACC to be at that time, outside of any pricing determinations, which are expected to be useful and reduce uncertainty for all stakeholders affected by the decisions[1].

The AER's final guidelines and explanatory statement should include sufficient detail for stakeholders to understand in advance of the determination what evidence will be considered and how the AER will apply its judgement in making a determination on the fair cost of equity for an NSP.

Cost of equity:

As discussed above, the assessment process for the overall cost of capital and return on equity should be given more detail in the final guideline and explanatory statement. Several sources of evidence have been listed which are difficult to interpret.

The AER has failed to set out for stakeholders how these forms of non-model evidence would be used to fairly inform the AER's judgment and what weight they would receive in determining the appropriate cost of equity out of a potentially wide range defined by the foundational model.

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[1] IPART 2013, WACC Methodology Draft Report, September, pp40-41

ActewAGL House 40 Bunda Street Canberra ACT 2600 I GPO Box 366 Canberra ACT 2601
t 13 14 93 I f 02 6249 7237 I actewagl.com.au

ActewAGL Distribution ABN 76 670 568 688 a partnership of ACTEW Distribution Limited ABN 83 073 025 224 and Jemena Networks (ACT) Pty Ltd ABN 24 008 552 663.

The foundation model chosen by the AER is the Sharpe Lintner Capital Asset Pricing Model (CAPM), as has been used by the AER in the past. The use of the Dividend Growth Model (DGM) at the benchmark firm level has been excluded, as has the Fama-French three factor model. By excluding these models from consideration, the AER may be failing to comply with the requirements of the Rules to have regard to relevant models and evidence. ActewAGL considers that these models should be included at the overall rate of return level, as set out in the ENA's transparent multi-model approach.

The AER has indicated that a market-wide DGM will be given some consideration for setting the Market Risk Premium (MRP) parameter in the foundation model. ActewAGL notes that the DGM will actually produce an estimate of the market return (R_m), which the CAPM should use, rather than an MRP parameter directly, since the MRP itself is defined as the difference between the required return on the market and the current risk free rate. Because the DGM uses more up-to-date market data, it typically provides a better estimate of this than the previous assumption that the best forward-looking estimate of R_m was the current yield on 10-year government bonds plus a six percent MRP.

Another method supported by Professors Wright and Gregory and used in the UK, is to estimate the long-term average R_m as the best forward-looking estimate of that parameter. This approach may overstate the stability in investor return expectations over time, but is also more appropriate than the previous assumption of a six percent MRP. The 'Wright Approach' also avoids the sensitivity to inputs that simple DGM models have[2]. ActewAGL notes that consumer groups expressed support for this 'Wright Approach' assumption in the stakeholder forum of October 1, 2013, particularly in regards to the multiple-decade horizons that key infrastructure projects entail.

The 'Wright Approach' has been given some consideration in the draft guidelines, but only as an overall check of the cost of equity from the foundation model. ActewAGL considers the model would be better included as informing the appropriate forward-looking R_m parameter[3].

Cost of debt:

The AER's draft guideline changes the benchmark term of debt to 7 years, from the previously widely adopted 10 years. ActewAGL considers this to be unrepresentative of the longevity of the assets in use by the industry and is likely to lead to material under-recovery of the benchmark firm's efficient cost base and to encourage DNSPs to adopt shorter-termed financing arrangements. It is also inconsistent with recent Australian Office of Financial Management, State Treasury and other market participants who have increased debt issuance in the 10 year and beyond tenor range to cater for increasing long-term debt appetite given the continued growth in longer dated superannuation fund demand.

ActewAGL supports maintaining the 10-year benchmark term of debt. While there are practical problems with estimation of the 10-year yield in lieu of a published bond index, in recent decisions the 7-year Bloomberg index has been extrapolated to 10 years. ActewAGL considers that this approach should be maintained – the best benchmark term for its efficient cost of debt remains 10 years or longer. Setting a lower benchmark tenor exposes DNSPs to the risk of under-recovery of efficient costs or increases the rollover risk and debt raising costs substantially, particularly for a smaller utility where costs would not scale proportionally with the size of financing needs.

Practical difficulties of estimating the 10-year yield annually could be overcome. As a lower bound for the term premium between a 7-year and 10-year tenor, the difference in yields between 7 and 10 years shown in the CGS yield curve is easily observable and automatically updateable. The ENA's submission explores this

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[2] ActewAGL considers that the required return on the market is relatively stable over time, which the MRP fixed at six percent approach fails to capture. More detailed DGMs which include a glide path, such as Bloomberg's and SFG's typically show more stability over time, especially in the post-2008 period.
[3] The MRP is calculated as the R_m less the current risk free rate.

issue further and includes methods to fairly estimate the additional yield, which can be estimated on an annual basis as required.

ActewAGL notes that one of its shareholders, ACTEW Corporation Ltd, issues very long term debt, over multi-decade periods, and that this makes up the vast majority of its liabilities. The weighted average term at issue of its debt issues since 2000 has been slightly over 21 years[4], and the remaining principal represents over 70 per cent of total liabilities. ACTEW's investments include its holdings in ActewAGL Distribution as well as its own water utility business with similarly long-lived assets.

ActewAGL maintains its view, expressed in its submission to the Consultation Paper, that the best approach for its cost of debt allowance is a trailing average. This aligns with the practice of issuing long-tenor bonds and avoiding rollover and refinancing risk by including a range of issue dates. ActewAGL considers that the portfolio approach has always been an appropriate financing practice, and as such a transition may not be necessary for businesses that already follow this approach. While other NSPs may support transitions from one benchmark (i.e. the current approach) to another (i.e. the trailing average approach), the AER should not interpret such a preference as evidence that no transition is inefficient.

Gamma:

ActewAGL supports the ENA's submission on the value of imputation credits (gamma), and considers that the dividend drop off studies remain the best evidence on the market value of imputation credits. The component of the gamma calculation that the Draft guideline changes (theta), should reflect the value of imputation credits and cannot be calculated from the ATO's tax statistics. In 2011 the Australian Competition Tribunal determined 0.25 for gamma as the appropriate value based on the dividend drop-off studies and updates of the analysis attached to the ENA's submission have found no significant change since the Tribunal's decision.

ActewAGL is pleased to participate in the AER's Rate of Return guidelines consultation process. Should you wish to discuss any of the matters raised above please contact Mr Björn Tibell on (02) 6248 3639.

Yours sincerely

David Graham

Director Regulatory Affairs and Pricing

[4] ACTEW Corporate Limited 2013, Annual Report to the ACT Government 2012-13: General Purpose Financial Report for the year ended 30 June 2013, p46.