Consumer
Challenge
Panel

CCP10 Response to AER Position Paper:

December 2017

Remitted debt decisions for NSW/ACT 2014–19 electricity distribution determinations and Jemena Gas Networks 2015-20 (NSW) Access Arrangement

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Contents

Remembering Dr Gill Owen

This submission includes a reference to CCP1's earlier commentary on "a new reality" which we note was drafted by Dr Gill Owen, who's work, particularly in the interests of disadvantaged consumers was honoured on 7th February, through the AER's hosting of a memorial lecture.

We add our appreciation for the contribution of a valued and fondly remembered CCP colleague.

Submission outline

In the position paper, the AER invites "interested parties to make submissions on any issues they see with our proposed approach. This may include (but is not limited to):

- Our interpretation of the orders of the Tribunal and Full Court
- Our interpretation of the relevant rules and law
- Our proposed approach to setting the cost of debt in these remittal decisions"

This response is presented in three sections:

- Section 1 summarises the context for making the remitted decisions, comments on the process undertaken and refers briefly to inflation aspects
- Section 2 deals with aspects of the legal issues related to making the remitted decisions
- Section 3 considers specific aspects of the debt issues under consideration

Section 1

Context, Principles and Process

1. Context for remitted decisions

The context in which this Position Paper has been released is significant, as the last decade has seen several critical shifts in the regulatory environment in NSW/ACT. We have summarised some of the key elements of these shifts to highlight aspects of this context. We believe this is relevant to factors that the AER should take into account in remaking the remitted decisions

The global financial crisis of 2007-08 (GFC) had the impact of significantly increasing the cost of capital, globally. Energy network businesses are capital intensive. This means that the cost of capital significantly impacts on their cost of business and ultimately the price charged to consumers, in this case for distribution use of system charges, known as DUoS. Consequently, the regulated price for the NSW/ACT distribution businesses for 2009-14 included a much higher allowance for the cost of capital than the prevailing rate up to the GFC.

The history of increased Reliability Standards in NSW also meant that each of the businesses was required to invest greater capital to meet these standards, increasing the size of each businesses' Regulated Asset Base (RAB) to which the increased cost of capital was then applied; further driving up prices. Prices for consumers continued to rise with network charges being singled out in popular commentary as the main driver of price increases of energy bills for all customer classes. The term ‘gold plating’ was used frequently in reference to electricity networks.

Significant changes to network regulation rules were made in 2012 and separate decisions were made to focus any Limited Merits Review appeals on AER decisions to meet a consumer benefit test. In mid-2013 the Productivity Commission emphasised the loss of centrality of consumers in network regulation and also discussed the value of benchmarking in regulation. Meanwhile the AER undertook a comprehensive development of guidelines under the banner of "better regulation" during 2013 to consider application of the new network regulation rules.

When the AER came to make the 2014-19 regulatory determinations, the three NSW Government owned distribution network businesses and ACT's ActewAGL were the first businesses to which the 2012 rule changes would be applied. Since the regulatory process could not be commenced until the guidelines were established, a placeholder decision was made for the first year of the regulatory period, with a "true up" to occur once regulatory determinations were made for the full 5-year period, 2014-19.

The final determinations were for reductions in allowable revenue from the regulatory proposals of 33%, 28%, 31% and 31.5% percent for Ausgrid, Endeavour, Essential and ActewAGL respectively. The main component of the reductions being to apply rates of return to capital that reflected much lower post GFC rates and a reduction in operating expenditure (opex).

The network businesses all appealed the AER’s decisions to the Australian Competition Tribunal (the Tribunal) by seeking limited merits review (LMR), a process which itself had also been subjected to changes.

The Tribunal upheld the network businesses’ appeals regarding return on debt, operating expense allowance and the rate for imputation credits relating to tax allowance. The Tribunal set aside the AER’s original decisions and directed the AER to remake the 2014-19 decisions, taking into account the Tribunal’s reasons.

The AER appealed the Tribunal decisions to the Federal Court. During 2017 the Federal Court decisions have been made, reinforcing the Tribunal’s decisions that the original decisions should be re-made by the AER, though with regard to a smaller number of issues. It is the remaking of the 2014-19 decisions that the AER is now undertaking, with limited direction on some aspects from the Tribunal and Court.

The time taken with the various appeal processes means that in remaking these decisions:

a) the AER and businesses have access to the actual expenditure of each of the businesses for the first 3 years of the regulatory period. It is very rare that a regulator’s decision can be made with considerable actual, revealed costs data to draw upon, and

b) the regulatory proposals for the next period, 2019-24 are due to be lodged with the AER before the remitted decisions will be made, using standard regulated price determining processes.

A core implication of the background for remaking the 2104-19 decision is the uniqueness of the situation. In practice, there is no handbook or rules to follow that deal with this combination of unique circumstances, including the historically turbulent financial circumstances of the past decade that have been a significant factor in driving at least some aspects of the unprecedented regulatory situation of the last decade, and the last 4 years in particular.

Current Situation

In attending a range of consumer consultation events and talking with energy businesses as well as consumer groups, it is abundantly clear that the most important energy issue for residential and business customers is price. There is a clear expectation from consumers that future prices will be lower than the current very high prices.

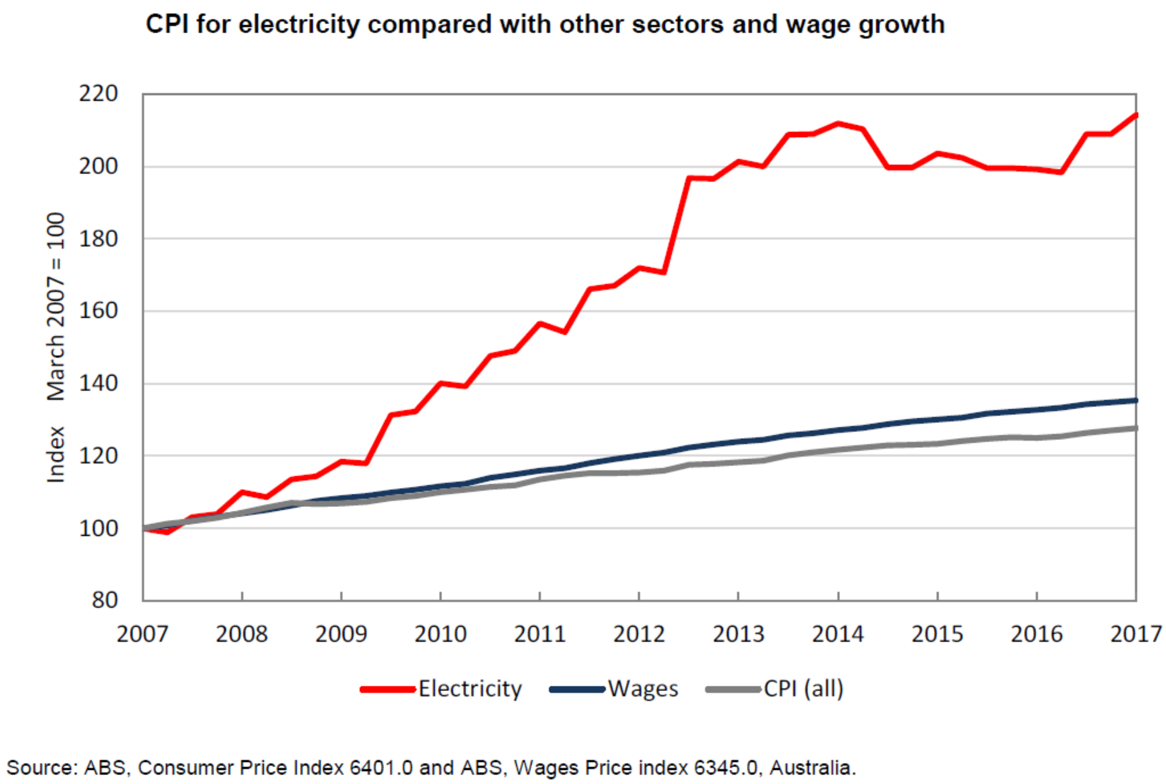

Figure 1: CPI for Electricity compared with wage growth, 2007 – 17

(Source ACCC Retail Electricity Pricing Inquiry: Preliminary Report)

The cost of living pressures exacerbated by high and rising energy costs are summarised by figure 1 which is taken from the ACCC progress report on retail energy prices[1].

This chart is presenting aggregate data, NEM wide, but similar data applies to individual NEM jurisdictions. The chart justifies the concern of consumers that energy prices have risen at a much faster rate than wages or CPI. Note that incomes of recipients of transfer payments are more likely to align with CPI rather than wages, so

[1] https://www.accc.gov.au/publications/accc-retail-electricity-pricing-inquiry-preliminary-report

the impact of high and rising energy costs on lower income people is greater than for ‘average’ households.

There is no escape from the reality that consumers are paying very high prices for electricity across the NEM, including in NSW and ACT, and that rapid price increases are having deleterious impacts in households as well as businesses. While price increases have been a little lower in ACT than in NSW, in aggregate, the reality of high and rising electricity prices in both jurisdictions remains.

2. Principles

In recognising the uniqueness of the circumstances leading up to the current 2014-19 remits for NSW and ACT network businesses, and observing the significant price impacts on households and businesses of rapidly rising energy costs, CCP10 has proposed principles to help shape the more specific aspects of the matters raised in both the Issues Paper dealing with opex and now the position paper regarding debt.

We proposed the following 10 principles in our response to the Opex issues paper and more recently at a discussion with Jemena Gas and the AER regarding capex matters relating specifically to the remitted decision for Jemena gas. The principles being:

1. The AER’s focus must be on the National Electricity Objective (NEO) without ignoring shorter-term impacts as well;
2. A recognition of the uniqueness of the current situation;
3. The AER should use the best available evidence;
4. The AER must apply the Tribunal and Federal Court directives, where they exist;
5. There is a process to transition from an inefficient network business to an efficient business;
6. There should be objective fairness between businesses;
7. Levels of opex must be sustainable;
8. The AER (and other stakeholders to) is dealing with “a new reality”;
9. Making remit decisions as a whole and
10. Trust and goodwill are needed to produce outcomes that work for all parties.

A more detailed discussion of each of these principles was discussed in our response to the opex issues paper.

Approach taken in remaking these decisions

Making the remitted decisions has also been one of the first opportunities to demonstrate AER 2.0 in application. The notion of AER 2.0 was first announced by AER Chair, Paula Conboy at a presentation to an ENA conference in July 2017, she evoked a spirit of greater cooperation and collaboration between network businesses and the regulator as being in the best interests of all parties and particularly consumers, as required by the national energy objective. Paula committed the AER to making efforts to apply this more collaborative approach and referred to it as "AER 2.0"

CCP subpanels have worked on implementation of this concept and have interpreted it to be summarised by the phrase "no surprises" meaning that any formal proposal from a network business or decision, draft or final, from the regulator should come as no surprise to other parties. For the CCP subpanels no surprises has meant that we have endeavoured to keep all parties informed of our views and perspectives and have given particular attention to ensuring that consumer interests are an integral part of "no surprises." We note that no surprises does not necessarily mean agreement, rather it means that all parties are fully aware of the data and perceptions informing the position that any party is taking on a particular topic. Of course agreement is highly desirable, but we believe the spirit of AER 2.0 is very much about transparency and building goodwill and understanding.

The more public process associated with remaking 2014-19 decisions started on 16th of August 2017 when the AER hosted a Roundtable of representatives from the businesses involved, consumer groups, key AER staff and CCP 10 subpanel members. We observed that this was an important starting point that both provided an opportunity for all parties to express their views, concerns and even aspirations without needing to 'lock in' any positions or commitments. We also believe that this meeting gave imprimatur to relevant subject experts particularly from network businesses and the AER to explore the detail of the issues under consideration.

For CCP 10, our role developed as one of facilitating and encouraging discussion and negotiation between all parties, particularly including key consumer interests. The role of CCP is to provide advice to the AER. What unfolded during intense and productive debate particularly during November and early December 2017 was that CCP 10 members were able to make observations to all relevant parties and to help keep everyone informed and focused on the key topics at hand. It is also our suggestion that CCP 10 was able to be nimble in being able to highlight key points of debate to relevant people in a very prompt manner.

The process developments that we have observed that have occurred in considering making the remitted decisions, when compared to past practice have included:

1. The conducting of a Roundtable of all key stakeholders early in the process, hosted by the AER. The purpose of the Roundtable being to both explore key issues and process.
2. "Licence" for the people with specific expertise in network businesses and AER to be able to get together and talk through issues concerns and seek resolution through ongoing discussion. This is not a brand-new process but we observe greater willingness on both sides for this to occur.
3. A more pragmatic approach from both network businesses and the AER in teasing out matters of regulator "judgement" with a stronger "no surprises" approach.
4. A greater level of involvement of consumer interests in the negotiation and discussion phase of discussions about key issues, rather than the past practice

of consumer groups being presented with a ‘fate accompli’ presented to them in formal documents.

5. The CCP being active in supporting informal as well as more formal information flows between all parties.

The CCP considers that each of these developments that have played out during the consideration of the remittal process have all been constructive and helpful developments in regulatory process that should be carried forward into future regulatory arrangements. We consider that there have been high levels of respect shown by all participants to each other and that there has been clear desire to find practical and efficient solutions to each of the issues that have been considered over recent months

Inflation

CCP15 was asked to confirm the calculations underpinning the revised calculation sent from the AER to the various networks in late 2017.

We refer to the letters from the AER to Jemena, Transgrid, Endeavour, Ausgrid, and ActewAGL dated 15 December 2017 referring to the proposed correction of an inflation calculation error in their relevant revenue determination periods. We agree with the AER’s proposal to revoke the relevant access arrangement and substitute a new access arrangement based on the revised calculation of the inflation rate to apply for the relevant period.

Legal Issues

CCP10 agrees that the AER’s position of remaking the remitted decisions by applying the reasoning in the APA VTS gas access arrangement (APA VTS) to transition the NSW/ACT DNSPs over 10 years from an on-the-day approach to a trailing average debt estimation methodology is consistent with the NEO and recent legal decisions. In our view, the main legal issue is whether there is anything in either the Ausgrid Tribunal or Ausgrid Federal Court decisions or orders that would prevent the AER from remaking the 2014-19 NSW/ACT decisions using its revised NPV=0 approach. For the reasons set out in the attachment on legal issues we conclude there is not.

Debt Issues

CCP10 supports the AER proposal to adopt the trailing average with a revenue neutral transition as it is:

1. consistent with the NEO and ARORO
2. consistent with efficient debt costs and efficient pricing
3. avoids the creation of windfall losses or gains for either the NSP or the consumers

At this time the alternative proposed by some – but not all – NSPs of adopting the trailing average without a transition would see consumers pay twice for the high interest rates during the GFC. This creates a windfall gain for the NSPs and results in prices that exceed economically efficient prices.

As the AER notes, the alternative to adopting the trailing average with a transition that is consistent with the NEO and ARORO is to continue setting debt costs using the on-the-day rate. Adoption of the trailing average with a transition better meets the long-term interest of consumers because it provides greater price stability.

We discuss these issues on the attachment on economic issues.

Section 2
Legal Issues

Summary

CCP10 agrees that the AER's position of remaking the remitted decisions by applying the reasoning in the APA VTS gas access arrangement[2] (APA VTS) to transition the NSW/ACT DNSPs over 10 years from an on-the-day approach to a trailing average debt estimation methodology is consistent with the NEO and recent legal decisions. In our view, the main legal issue is whether there is anything in either the Ausgrid Tribunal or Ausgrid Federal Court decisions or orders that would prevent the AER from remaking the 2014-19 NSW/ACT decisions using its revised NPV=0 approach. For the reasons set out in this attachment we conclude there is not.

Relevance of context

When considering the relevance of prior legal decisions, it is critical to focus on the context of the decisions being reviewed by the Tribunal and the Federal Court. The context for each of the AER's debt estimation methodology decisions since 2015 in NSW/ACT and other jurisdictions has been for the AER to exercise its discretion under the 2012 Rule amendments by transitioning from the mandated on-the-day approach to a new trailing average methodology. The context of each of the Tribunal decisions referred to below was a limited-merits review of the specific AER determination(s) being reviewed. Appeals from the Tribunal to the Federal Court are narrow and take the form of judicial review (ie a review for errors of law of the Tribunal.) Judicial review decisions are necessarily confined only to a review of the process of the specific Tribunal when it conducted a specific limited merits review. The Federal Court regularly reinforces the limited judicial review jurisdiction in its decisions. For example, in the recent SA Power networks judgement[3] the Court stated:

> *In AER v Australian Competition Tribunal, the Court considered at some length, at [133]−[159], the Tribunal's authority and the function of the Court on judicial review of a decision of the Tribunal. We do not repeat that analysis here, except to repeat the observations made by an earlier Full Court in Pilbara Infrastructure Pty Ltd v Australian Competition Tribunal [2011] FCAFC 58; 193 FCR 57 at [16], as follows:*

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[2] AER Final Decision APA VTS gas access arrangement 2018-2022 November 2017

[3] SA Power Networks v Australian Competition Tribunal (no 2) [2018] FAFC 3 at p 3

> *It is not this court's function to resolve the difficult and complex matters of judgment raised by the evidence and resolved by the Tribunal. This court's role in reviewing the decision of the Tribunal is to ensure that the decision of the Tribunal accords with the law. In Re Minister for Immigration & Multicultural Affairs; Ex parte Applicant S20/2002 (2003) 198 ALR 59; 77 ALJR 1165 at [114] it was said that it is no part of the supervisory jurisdiction of this court to*
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>> *…..enter upon a consideration of the factual merits of the individual decision. The grounds of judicial review ought not be used as a basis for a complete re-evaluation of the findings of fact, a reconsideration of the merits of the case or a re−litigation of the arguments that have been ventilated, and that failed, before the person designated as the repository of the decision−making power.*

Context for the AER determinations

In the lead-up to the 2012 Rule Amendments, interest rates had been falling and the AEMC was concerned that the mandated on-the-day approach was resulting in inefficient debt management practices. Once the AER had been given a discretion about which methodology to choose, the AER concluded that compared to the on-the-day approach a trailing average approach would lead to less volatile cash flows and would reduce risk for the network businesses. The AER did not want to shift immediately to the trailing average methodology as in an environment of falling interest rates this would over compensate the businesses by giving them a windfall and would not be consistent with the NEO and the ARORO. In decisions since the original NSW/ACT decisions in 2015, the AER has used a different approach to support a 10-year transition to the trailing average approach. The AER believed that a revenue neutral transition was essential for the change in methodologies to be in the NEO.

The 2014-19 decisions

The rationale used by the AER in the 2014-19 NSW/ACT decisions was that a BEE with efficient financing practices would have a staggered 10-year borrowing portfolio and that it would be likely to have hedging contracts that it would need to unwind over the 10 years. This rationale was rejected by the Tribunal (the Ausgrid Tribunal). The Federal Court subsequently found the Ausgrid Tribunal’s decision did not contain legal error on this issue (the Ausgrid Federal Court). Following the Ausgrid Tribunal decision in February 2016, the AER re-evaluated its approach to debt including the debt estimation methodology. The AER’s new approach does not rely on an assessment of historical financing practices, instead it considers efficient financing costs in a forward-looking manner[4]. The AER's revised approach is set out in the APA VTS decision and is based on an implied requirement of the NEO and RPP to ensure a zero NPV condition was satisfied over the life of the RAB (the revised NPV=0 approach).

The ActewAGL and Victorian Tribunal decisions

The recent decisions by the Tribunal in the SA Power Networks, ActewAGL (Gas) distribution and Jemena Electricity Networks to uphold the AER's revised NPV=0 approach is a very significant turning point, as the AER can now be confident in its revised NPV=0 approach when making future decisions. The AER must remake the NSW/ACT 2014-19 decisions and it proposes to use its revised NPV=0 approach as the basis for those remade decisions. Clearly the AER's remitted decisions must comply with the Ausgrid Tribunal and Federal Court directions arising from the NSW/ACT appeal. In our opinion, the main legal issue is whether there is anything in either the Ausgrid Tribunal or Federal Court decisions or orders that would prevent the AER from remaking the same decisions by using the revised NPV=0 approach.

The Ausgrid Tribunal's order

When the Ausgrid Tribunal decided to set aside the original AER NSW/ACT Final Decisions for 2014-19 the AER was ordered to '*remake its decision on return of debt in relation to the introduction of the trailing average approach <u>in accordance with these reasons for decision</u>*'. We agree with the AER's observation that the Tribunal did not give a clear clarification of this direction[5]. The NSW/ACT businesses also appear to share this view as subsequent to the decision the businesses sought further clarification from the Tribunal about its order and how the AER should remake the debt decision. On 17 March 2017 the Tribunal refused the application to provide this clarification.[6]

As part of its reasons for decision the Tribunal set out the AER's rationale at that time for the transition:

> "[867] *The AER's transitional approach, adopted in each of the Final Decisions under review and apparently in all regulatory decisions for the current regulatory period, was based on a regulated entity as the BEE which (it considered) would have a portfolio of floating rate debt that, had the on-the-day approach continued, it would have swapped into a fixed rate debt during the relevant*

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[4] AER Position Paper at 14

[5] AER Position Paper at 10

[6] http://www.competitiontribunal.gov.au/documents/act2015/ACT8-directions-14Mar2016.pdf

averaging period. Consequently, the BEE would have unwound its hedging contracts in moving from the current on-the-day approach to the trailing average portfolio approach."

The Tribunal subsequently found errors in the foundation for this rationale for the transition, namely that the AER had wrongly concluded that the BEE was regulated. The tribunal noted:

"[927] *If a different starting point, that is a different BEE efficient financing cost structure, is adopted, it is then necessary to revisit the AER's approach to, and consideration of, the factor to which it must have regard under r 6.5.2(k)(4)……*

[939] If the changed methodology might produce benefits to a particular DNSP (as it was suggested, might be the case because of some carry forward windfall arising from the previous methodology) it may be that s 16(1)(d) of the NEL in the case of the AER would require some alterations to what would otherwise be an appropriate transition process. That is not a matter which was much debated in the course of submissions.

[940] As the Tribunal proposes to remit the matter to the AER…..it is not necessary or appropriate to explore those alterations in detail at present."

Whilst the Ausgrid Tribunal made some comments about what was involved in an assessment of efficient financing costs in paragraphs [934-935] those submissions support why the Tribunal found that the AER needed a 'different starting point'. The Tribunal made no further observations about the transition between the 2 methods. Accordingly, provided that the AER chooses a different starting point for the efficient costs, such as the revised NPV=0 approach, then CCP10 believes that it is open to the AER to remake its decision complying with the Tribunal direction provided that it does not make the same errors as it did in its original rationale.

The Ausgrid Federal Court decision

The Full Federal Court decision reviewing the Ausgrid Tribunal was an application by the AER for judicial review of the Ausgrid Tribunal's decision[7]. Therefore, the Court was deciding if the Ausgrid Tribunal had made an error in its decision on debt and its decision to set aside the original AER Final Decision and remit it to the AER to be remade. The Ausgrid Federal Court decision provides no greater guidance on whether

[7] Australian Energy Regulator v Australian Competition Tribunal (no 2) [2017] FCAFC 79

a transition between debt methodologies should be immediate or revenue neutral. Instead, the Court focussed on the Tribunal's interpretation of the BEE concluding that the BEE should be taken as having a similar degree of risk as that which applies to the particular service provider in providing regulated services. The Court added to the Tribunal's interpretation by concluding that this does not mean that the BEE must be characterised as a regulated entity.

We agree with the AER's observations about the limited relevance of the judicial review context of the decision. There is nothing in the Ausgrid Federal Court decision that elaborates on how the AER should remake the decision or the Tribunal's order other than the issue of whether the BEE is regulated or unregulated. In our view, the Ausgrid Federal Court decision does not prevent the AER from applying its revised NPV=O approach in its remade decisions, provided the new approach doesn't contain the errors about the BEE that the Ausgrid Tribunal and the Court identified.

Relevance of the Victorian Tribunal decisions

We agree with the AER's conclusion that the recent Tribunal decisions for ActewAGL (Gas) Distribution and Jemena Electricity Networks Ltd are particularly important[8]. This relevance arises as the Victorian Tribunal decisions were appeals against the AER's decisions using its revised NPV = 0 approach that a revenue neutral transition between debt estimation methodologies was required to meet the ARORO. Helpfully the Tribunal referred to the Ausgrid Tribunal and the Ausgrid Federal Court decisions in its analysis and in upholding the AER's decision to require the 10-year transition the Victorian Tribunal made the following statements to underpin the relevance of its decision to future AER decisions (including the remitted decisions):

- the AER's imposition of a transition to the historical trailing average approach is essentially the same issue as was raised in relation to debt by the parties in *Ausgrid* and in SAPN[9]
- in *Ausgrid* the Tribunal's focus was on the rationale for transition, particularly the proper definition of the BEE and interpretation of r 6.5.2(k)(4)…and the Tribunal in that matter concluded that the AER had misinterpreted the definition of a BEE as a regulated entity with hedged debt that required transition to the HTA approach[10]
- the AER subsequently adopted a different approach for applying the revenue neutral transition to the trailing average approach in the recent determinations for SAPN, ActewAGL and Jemena, relying on an implied requirement of the NEO and RPP to ensure a "zero NPV" condition was satisfied "over the life of

[8] Ibid at 11

[9] ActewAGL [2017] ACompT 2 at [63]

[10] Ibid at [63]

the RAB"[11]

- this revised approach was contested in SAPN but was accepted by the Tribunal in that matter[12]
- since the 2012 amendments the NEL gives the AER a discretion to choose between the on-the-day approach, a trailing average approach or a combination of these 2 approaches[13]
- it is essential to read the Ausgrid Full Court's reasons in the context of the questions it was considering which was whether the Ausgrid Tribunal erred in law in concluding that the AER was bound to address the ARORO on the basis that the BEE must be an unregulated entity[14]
- it is uncontroversial that the AER seeks to estimate the required rate of return…of a company that has a similar degree of risk to the regulated company but is operating in a workably competitive market[15]
- there is no tension between this view and the statements by the Ausgrid Full Court. In particular, the term 'efficient financing costs' embodies the *ex-ante*, forward-looking expectations-based framework described by the Tribunal[16]
- it is indisputable that providing a return on debt partially based on the much higher interest rates of some years ago to Jemena and ActewAGL, neither of whom has any debt, would give them a windfall gain. This would be inefficient. Their allowed revenue would be higher than needed to cover their costs[17]
- Jemena and ActewAGL do not have debt borrowed at higher rates, or any debt. There is no need – and it would be inappropriate – to adopt a fiction that a BEE would have had such debt obligations. Nothing in the ARORO could support an outcome so starkly at odds with the LTIC. It would simply be a transfer from consumers to the service providers[18]
- it is relevant to consider whether an approach to estimating the return on debt is neutral with respect to past interest rates[19]
- the AER considers that a rate of return that meets the ARORO must provide ex-ante compensation for efficient financing costs….This is a zero NPV investment condition[20]
- the Tribunal agrees that the zero NPV condition is consistent with the NGO and RPP and considers that, consistent with achievement of the ARORO, it represents a criterion that should be satisfied, to the greatest degree

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[11] Ibid

[12] Ibid

[13] Ibid at [69]

[14] Ibid at [103]

[15] Ibid at [112]

[16] ibid at [122]

[17] ibid at [144]

[18] Ibid

[19] Ibid at [146]

[20] Ibid at [154]

practicable, by the approach used to assess the rate of return and the returns on equity and debt[21]

- the AER was correct to consider that the immediately implemented trailing average approach would be less likely than the on the day approach to contribute to the ARORO[22] and
- the widely held view is that in due course a fully implemented trailing average approach will be superior to a continuation of the on the day approach– the clear option is a combination of the on-the-day approach and fully implemented trailing average. The transition that the AER decided upon is such a combination…….and it is a matter for the AER to decide which of the 3 approaches could contribute to the ARORO in each particular case[23]

It is clear from the above analysis that the result of the SAPN and Victorian Tribunal decisions is that the Tribunal supports the AER's revised NPV=0 approach and believes that it is in the NEO and meets the ARORO.

Relevance of the SAPN Federal Court decision

On 18 January 2018, the Federal Court dismissed SAPN's application for judicial review of the SAPN Tribunal decision[24]. The SAPN Federal Court found no error in the SAPN Tribunal decision which had also upheld the AER's determination based on the revised NPV=0 approach. The SAPN Federal Court decision represents further Tribunal and judicial support for the AER in it use of the revised NPV=0 approach. For instance, at [253] the Court stated:

> *Rule 6.5.2(k)(4) requires the AER, when estimating the return on debt, to have regard to impacts that could arise as a result of changing the methodology that is used to estimate the return on debt. When the AER came to consider the impacts of changing the methodology from the on-the-day approach to the trailing average approach, it took into account how 'windfall' gains or losses, in the sense described above, could be avoided. We see no error in that approach.*

However, it is important not to overstate the relevance of this decision to the remittals. As discussed above judicial review is a narrow review of a specific decision. As the SAPN Federal Court noted even the Ausgrid Federal Court decision which appears to

[21] ibid at [155]

[22] ibid at [187]

[23] Ibid at [189]

[24] Supra note 2

raise some similar issues bore little relevance to the issues in the SAPN decision. The Court held at [290] "*Further, the issues before the Tribunal under review in the present proceeding are quite different to, and distinct from, the issues before the Tribunal that were under review in AER v Australian Competition Tribunal*".

The SAPN Federal court did confirm the AER's view (and our opinion discussed above) that the Ausgrid Federal Court had given no guidance to the AER on the transition between methodologies. The SAPN Court stated:

> *[295] We would add that the present proceeding has raised a number of issues that were not advanced by the parties in AER v Australian Competition Tribunal. The full court's observation at [572] of AER v Australian Competition Tribunal that there were no impacts in the form of hedging contracts that needed to be unwound was made in the context of the facts of that case and the submissions that were advanced by the parties at that time. No wider consideration of the possible 'impacts' of a change in methodology to estimate the return on debt was advanced or addressed. We do not regard AER v Australian Competition Tribunal as in any way confining the 'impacts' to which the AER might have regard when applying r 6.5.2(k)(4).*

CCP 10 repeats our opinion that the main legal issue is whether there is anything in either the Ausgrid Tribunal or Ausgrid Federal Court decisions or orders that would prevent the AER from remaking the 2014-19 NSW/ACT decisions using its revised NPV=0 approach. For the reasons set out in this attachment we conclude there is not.

APA VTS

CCP10 notes that following the Victorian Tribunal decisions the AER further refined its revised NPV=0 approach in the APA VTS decision. The refinement was to deal with observations and suggestions made by the Victorian Tribunal. The further refined NPV=0 approach in APA VTS is:

- a BEE is not necessarily to be characterised as a regulated entity[25]
- a rate of return that meets the ARORO must provide ex-ante compensation for efficient financing costs[26]
- the on-the-day approach provides ex-ante efficient compensation on debt capital over each period and over the life of the investment[27]
- the trailing average approach provides ex-ante compensation on debt capital

[25] APA VTS at 3-306

[26] Ibid at 3-309

[27] Ibid at 3-310

only over the term of the RAB if a revenue neutral transition is applied[28]

- both the on-the-day methodology to setting the cost of debt and a trailing average methodology can meet the ARORO[29]
- however, in moving between different approaches, only a transition that is revenue-neutral in a present value sense will meet the ARORO[30]
- the AER's transition approach meets the requirements of the ARORO, NEO/NGO and RPPs[31] as it is a revenue neutral transition[32] and
- by contrast an immediate transition to a trailing average would result in a material and unexpected change in the present value of a BEE relative to a value consistent with investor expectations formed under the on-the-day regime and would not meet the ARORO.[33]

CCP10 agrees that the approach underlying the APA VTS decision is consistent with the recent legal decisions discussed above.

Conclusion

By being indifferent to whether the BEE is regulated or unregulated and by shifting away from the original rationale to the revised NPV=0 approach to justify the revenue neutral transition to the trailing average, CCP10 believes the AER will be complying with the Ausgrid Tribunal's reasons for its decision as clarified by the Ausgrid Federal Court. Further CCP10 supports the AER's conclusion that the revenue neutral transition to the trailing average approach as set out in APA VTS applied to the NSW/ACT remitted decisions will meet the ARORO and the NEO for the reasons in the attachment on economic issues.

If a Court were to find that the AER could not remake the decision with the revenue neutral transition[34] CCP10 would support a return to the on-the-day approach rather than an immediate transition to the historical average. This would be because the on-the-day approach would better achieve the ARORO rather than an immediate change to a trailing average approach without a revenue neutral transition.

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[28] Ibid at 3-310

[29] Ibid at 3-316

[30] Ibid at 3-316 and 3-326

[31] Ibid at 3-317

[32] Ibid at 3-326

[33] Ibid at 3-318 and 3-327

[34] AER Position Paper at 19

Section 3
Debt Issues

Summary

CCP10 supports the AER proposal to adopt the trailing average with a transition as it is:
1. consistent with the NEO and ARORO
2. consistent with efficient debt costs and efficient pricing
3. avoids the creation of windfall losses or gains for either the NSP or the consumers

At this time the alternative proposed by some – but not all – NSPs of adopting the trailing average without a transition would see consumers pay twice for the high interest rates during the GFC. This creates a windfall gain for the NSPs and results in prices that exceed economically efficient prices.

As the AER notes, the alternative to adopting the trailing average with a transition that is consistent with the NEO and ARORO is to continue setting debt costs using the on-the-day rate. Adoption of the trailing average with a transition better meets the long-term interest of consumers because it provides greater price stability.

Efficient costs and prices: the requirements of the NEO and ARORO

The NEO is the overarching guiding principle guiding network regulation. It requires the AER to regulate NSP revenues and prices so as *to promote efficient investment in, and efficient operation and use of, electricity services for the long term interests of consumers of electricity with respect to – price, quality, safety, reliability, and security of supply of electricity; and the reliability, safety and security of the national electricity system.* The efficiency objective is interpreted in terms of economic efficiency which also underpins the Regulatory Pricing Principles. Two key principles of economic efficiency are the importance of opportunity costs and the irrelevance of sunk costs. Both principles support the use of current market rates as the measure of efficient costs rather than historic costs. These principles support the AER's arguments, founded upon ex-ante economic efficiency, for the use of either:
- the current market rates, or
- the trailing average *with a transition.*

The ARORO requires that the rate of return for an NSP is commensurate with the efficient financing costs of a benchmark efficient entity (BEE) with a similar degree of risk. The implication of the definition of the BEE and comparable risk is discussed below. In summary, the definition of the BEE only impacts the assessment of the cost of debt to the extent it affects the assumed gearing, credit rating and the maturity of the debt portfolio. Interest costs are specific to the nature of the debt instrument rather than the characteristics, of the issuing entity other than its credit rating.

What are efficient financing costs?

It is important to draw a distinction between the efficiency of finance markets and the efficient financing costs. There can be debate about the extent to which financial markets are efficient and the prices reflect 'rational expectations' or may be influenced by other factors. However, the principle of one price is widely accepted. That is, at any time there will be a relatively well-defined and generally narrow spread in the interest rates for a debt instrument of a specific type, such as 10 year BBB corporate bond. As the AER points out the current market interest rate is the opportunity cost of such instruments and the basis of valuation of the instrument. Thus, the current market interest rates are the efficient cost for an entity wishing to borrow funds using the relevant instrument. Of course, there are multiple possible debt instruments, but the use of 10 year BBB/BBB+ corporate bonds as the reference rate is broadly accepted. Thus, the ex-ante efficient cost at a point in time is the current market rate. This will reflect the opportunity cost of debt-financed new investment and, if used to set debt costs, will mean that the NPV of the cash flows for new investments will be zero.

As the AER demonstrates the adoption of the trailing average with a transition also satisfies this criteria that requires that the ex-ante net present value of costs and revenues is zero. The starting point – the cost of debt in the first year of the transition - is the same: the current market rate (the ex-ante efficient cost). Under this forward-looking approach the trailing average would build up over time. The debt costs added in each year would reflect the costs of financing the capex program in that year, consistent with the requirement under the NEO to promote efficient investment in the network. Furthermore, the prices would reflect the forward-looking efficient costs of supply in regard to the financing of capex.

Why the trailing average with transition is preferred to the on-the-day rate

During the development of the rate of return guidelines consumers supported the adoption of the trailing average approach. The adoption of the trailing average can

1. reduce transaction costs of debt
2. provide greater stability in the cost of debt over time, and
3. reduce the systematic risks for the networks, resulting in a lower beta, other things being equal.

However, the impacts of the move to a trailing average approach must be considered. We consider that the trailing average approach must include a transition period if it is to meet the NEO. From the consumers’ perspective, adopting the trailing average without transition will result in a windfall gain for the NSPs as customers pay twice for the high yields on corporate bonds during the GFC. (This is demonstrated below.)

The alternative to the adoption of the trailing average with transition would be continuation of the use of the on-the-day rate for all debt.

Why the trailing average without transition does not meet the requirements of the NEO and ARORO

As noted above, both the on-the-day approach and the trailing average with transition meet the requirements of ex-ante NPV neutrality. The immediate adoption or the trailing average does not meet these requirements because of the difference in the starting point. In the first year the allowed cost of debt reflects the historic costs of debt rather than the current or opportunity cost of debt. As such there is a mismatch between the cost of debt allowed and the efficient cost of debt for new investment. In the current circumstances the allowed costs of debt would be higher than the current cost of debt. The AER has provided mathematical support showing that in the current circumstances this results in a positive NPV as rather than the zero NPV required to satisfy the NEO and ARORO. From the consumer perspective this gain for the utility is a loss for consumers. The section below provides a simple illustration of this.

From year 10 the prices for consumers would be the same under either approach, but for the first 10 years the debt costs would be higher than if the trailing average were adopted without transition. Because of the difference in the starting point these approaches have different implications for the long-term interest of consumers. The differences in the impact on consumers arise from the difference in how sunk debt costs are treated (and the extent to which the NSPs are protected from the higher risks it took on through its choice of financing strategy). In effect consumers pay twice for past higher interest rates, as illustrated in figure 2 below.

The 2009-14 determination used the on-the-day approach, resulting in the cost of debt for 2009-14 being set at rates near the peak of the GFC. The NSPs have stated that they did not hedge their debt. As a result, the NSPs’ interest costs were lower than the cost of debt allowed, and they benefited from the decline in the interest rates to 2014. In not hedging the NSPs took the risk that, unless the rules were changed, debt costs would be set using the on-the-day approach in 2014, and the allowed cost of debt would be lower than their average cost of debt. Adopting the trailing average without transition retrospectively protects the NSPs from a risk that they knowingly took on and have benefitted from doing so. Furthermore, it results in consumers effectively paying twice for the high interest rates in the GFC: once in 2009-14 when interest rates were set using the GFC rates and again from 2014-15 when the high interest rates in that period result in a substantial wedge between the trailing average with and without transition (7.75% compared to 5.75%)

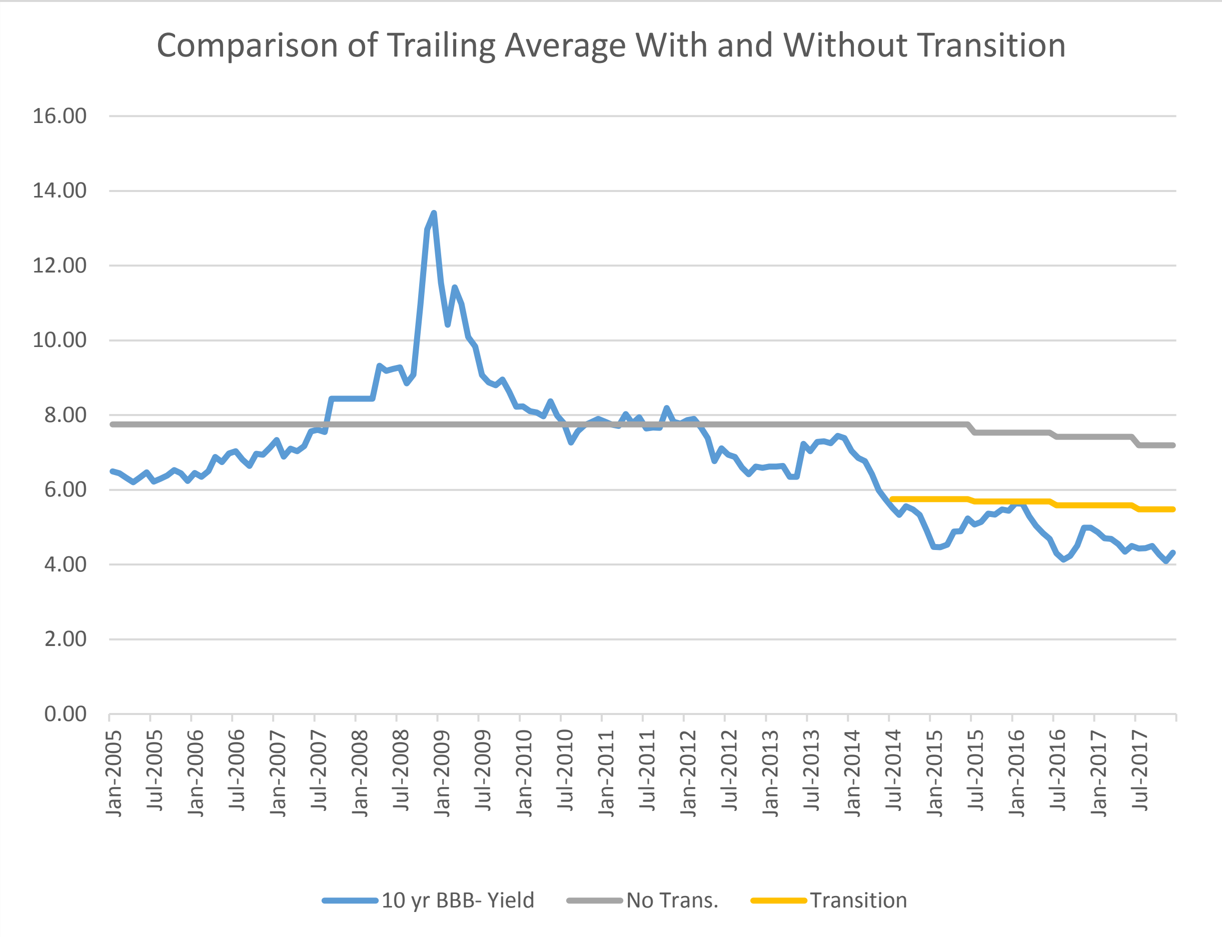

Figure 2: Source: RBA. Note the results are approximate as it uses RBA data on yields on BBB corporate bonds since 2005.]

This premium is effectively a transfer from the consumers to the NSPs as a result of the change in methodology that is contrary to the NEO because it arises from a cost of debt that exceeds the ex-ante efficient cost of debt and violates the zero NPV rule. In contrast, the adoption of the trailing average approach with a transition would do no more than leave the utility that did not hedge its borrowings exposed to the interest rate risk it knowingly took on.

Efficient debt costs and the Benchmark Efficient Entity

In the earlier decisions of the AER, such as the original decision in regard to the NSW Networks and ActewAGL, and subsequent appeals, much was made of the nature of the Benchmark Efficient Entity (BEE). However, the supporting arguments for subsequent decisions on the cost of debt are largely independent of the specific characteristics of the BEE.

It is important to distinguish between the efficient cost for a defined debt instrument – such as a 10-year bond issued by a non-financial corporation with a BBB/BBB+ rating and the financing strategy and costs of the entity. The interest cost of a specific debt instrument depends on the characteristic of the instrument. For example, it is generally assumed that the yield on a 10-year corporate bond is a function of the credit rating of the issuing corporation rather than the specific characteristics of the issuing corporation.

Some elements in the financing strategy are common across the determinations of the AER and appear broadly agreed. These are the gearing ratio of 60:40 and the use of 10-year corporate bonds with a BBB/BBB+ rating as the reference debt instrument. Although it should be noted that consumer submissions have argued that the choice of this instrument may result in overestimation of the cost of debt.

However, a financing strategy involves the construction of a portfolio of debt from a wide range of debt instruments (such as bank debt and hybrid debt-equity instruments in addition to corporate bonds), gearing ratios, maturity periods, currencies/markets, and hedging instruments (such as interest swaps, inflation swaps, and indexed debt). Importantly the choice of financing strategy depends on the entity's appetite for risk. Hence an efficient financing strategy cannot be uniquely defined for a generic BEE – it must assume a risk appetite that is unique to a specific entity and is not uniquely efficient.

This can be seen in the NSPs responses to the AER's past approach to determining the cost of debt. When the on-the-day rate was used, some NSPs tried to match the cost of debt to the allowed cost of debt through interest rate swaps. This entailed additional transaction costs for the NSP, but it reduced the NSP's risks. Other networks, perhaps with a greater appetite for risk, did not hedge. Neither could be said to be more efficient than the other ex-ante. Given the subsequent decline in interest costs, not hedging resulted in additional profits for the utility at the risk of future losses if the on-the-day rate continued to be used. In summary even though the strategy of not hedging may have resulted in lower ex-post interest costs in these periods it cannot be said to be more efficient because it also entailed greater risk.

Similarly, firms in competitive markets must consider their appetite for risk in optimising financing strategies. There is no single efficient financing strategy. In a text-book competitive market, prices are set by the costs of the new entrant or new investment. In this context, two conclusions can be drawn:

1. Prices set in competitive markets would be efficient and would reflect the on-the-day rates since that is the cost faced by the new entrant, and
2. Risk averse firms in competitive markets may seek to match their cost of debt to the current cost of debt in the market.

In practice, markets are less than perfectly competitive and the extent to which the competitive firm seeks to match the current market cost of debt will depend on its appetite for risk. Furthermore, one can observe that interest swaps are widely used by firms to manage their exposure to interest rate changes.

In summary, the yield for a specific debt instrument can be observed in the market place and will reflect market expectations at that time for the relevant period. In that sense it is the efficient cost for that instrument at that time. However, the efficient financing strategy cannot be defined independently of an entity's risk appetite. Hence there is not a unique, observable efficient financing strategy for a BEE.

Relevance of historic costs and actual financing strategies

One question raised in the appeals has been the extent to which the AER should have regard to historic costs or actual financing strategy of the DNSP. For example, the NSW Networks argued in their appeal that their adoption of the trailing average without transition better matched their actual financing strategy and costs.

Basing financing costs on the actual observed costs would be a substantial departure from the model of incentive-based regulation that underpins the current NER. It would be a significant move back towards cost plus regulation. An alternative could be to base the cost of debt on the actual financing strategy of the entity, using benchmark historic costs for the relevant debt instruments. In this case it cannot be said to represent the debt strategy of the BEE. The reference point is the strategy employed by the specific NSP. If so, the approach may well have limited incentive properties and approximate cost-pass through regulation in regard to debt costs. It would not provide an incentive to optimise the financing strategy but to avoid borrowing at higher than market costs given the financing strategy adopted. This would be at best a second-order incentive. Importantly if debt costs are to have regard to the actual financing strategy chosen, this would logically also apply to the gearing assumption. This would in turn raise the question of whether the assumed credit rating should be changed to reflect actual gearing. Arguably tax should then also be treated as a pass-through since tax minimisation is an integral aspect of financing strategies chosen.

Setting the financing strategy with regard to the financing strategy of the NSP and the 'face' interest cost of the embedded debt may reduce the risk for the NSP, but it would reduce the efficiency incentives and cannot be argued to be consistent with the efficient costs of the debt. The current efficient cost for a debt instrument is the current market yield of the relevant instrument, not the interest rate at which it may have been issued. Debt instruments are valued based on current market yields not the yield at time of issue.