

11 October 2013

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



Dear Mr Anderson

Energex response to AER's Draft Rate of Return Guideline

Energex welcomes the opportunity to submit a response to the Australian Energy Regulator's (AER's) Draft Rate of Return Guideline (the Draft Guideline). Overall, Energex considers that this process provides a significant opportunity for a more pragmatic, workable, yet robust approach to assessing the rate of return. From Energex's perspective, one of the most important goals is to achieve greater regulatory certainty (which is also important to investors and consumers), while retaining sufficient flexibility to implement what is an inherently imprecise science, including responding to changes in the financial market outlook.

A submission in response to the Draft Guideline has been submitted by the Energy Networks Association (ENA). A submission has also been made by Queensland Treasury Corporation (QTC) on issues associated with the cost of debt. Energex supports both of these submissions. The issues associated with the Draft Guideline have been comprehensively addressed in these submissions and it is therefore not intended to explore them in detail here. However, Energex would like to highlight some of the issues that are most important from its perspective.

Certainty and Transparency

Overall, Energex's overarching concern with the Draft Guideline is that it currently provides inadequate transparency and certainty as to how the AER will approach its assessment and make decisions about the rate of return at each revenue reset. As noted above, Energex recognises the need for the Guideline to provide an appropriate balance between prescription and flexibility. Currently, however, the Draft Guideline contains insufficient detail – including the absence of worked examples – to enable an assessment of how the rate of return will actually be assessed and the likely outcome (or range of outcomes) that could be expected in the current market environment. This is of fundamental importance to Energex as a network service provider approaching its next regulatory reset and is expected to be similarly important to consumers and investors in regulated energy network infrastructure.

Enquiries
Neil Andersen
Telephone
(07) 3664 4009
Facsimile
(07) 3664 9818
Email
neilandersen
@energex.com.au

Corporate Office
26 Reddacliff Street
Newstead Qld 4006
GPO Box 1461
Brisbane Qld 4001
Telephone (07) 3664 4000
Facsimile (07) 3025 8301
energex.com.au

Energex Limited
ABN 40 078 849 055

Regulatory certainty is important for a business and its stakeholders as it needs to be able to forecast its future revenues beyond the horizon of the current control period. Regulatory uncertainty and discretion also increases the risk of error and the likelihood that issues will continue to be subject to protracted and costly disputes.

One of the areas where there is considerable residual uncertainty is the determination of the cost of equity and in particular the practical application of the AER's foundation model approach in conjunction with other models and market evidence. With the consideration of these other models, data and evidence that is now required under the National Electricity Rules, it remains unclear as to the extent to which this other information will practically be given any significant weight, or how any material differences between the CAPM-derived estimates and the other information will be reconciled.

Energex notes that the ENA submission offers some pragmatic solutions. We would also welcome some worked examples as to how the AER will approach its assessment. With the delay in the completion of the separate analysis of beta, it is also extremely important that all stakeholders be given adequate opportunity to review and respond to the AER's beta analysis prior to the finalisation of the Guideline.

Cost of Debt

The issue of most concern to Energex in relation to the cost of debt is the AER's proposal to shorten the assumed term to maturity from ten to seven years. Consistent with other owners of assets with long economic lives, the preference is for the business to raise debt for as long as possible. This is a prudent and rational commercial strategy as it reduces exposure to refinancing risk.

The AER's proposed term to maturity of seven years does not have a robust empirical foundation. It is noted that it relies on data that reflects the strategies that regulated network business have had to employ in managing the issues and risks associated with the current 'rate on the day' approach. Most importantly, the adoption of a seven year term to maturity exposes the businesses to material financing risk.

Another key driver for the change in approach appears to be the issues associated with extrapolating Bloomberg's seven year BBB cost of debt to produce a ten year estimate. As demonstrated by the ENA and QTC, the difference between the seven and ten year cost of debt is material. Energex also notes that workable and transparent options have been presented to address the extrapolation problem, including the approach by QTC.

The other main concern with the AER's proposed treatment of the cost of debt is the use of a simple average to calculate the trailing average. This is an issue for any regulated network business that has a sizeable capital expenditure program during the regulatory control period. Given that capital expenditure in network businesses invariably follows a 'lumpy' profile characterised by large, less frequent investments, the consequences of a mismatch between the regulated cost of debt and the actual cost of debt can be significant and difficult to hedge in advance (as the exact amount and timing of future expenditures is rarely certain).

While the new trailing average approach is a significant improvement on the 'rate on the day' approach, under the simple average only one-seventh of the prevailing cost of funds that will apply to new borrowings will be reflected in the cost of debt. While the mismatch can be an additional benefit or cost to the business (and vice versa to consumers), given the large and uneven nature of network investments this mismatch is unlikely to 'average out' over the long term.

Energex therefore supports QTC's proposed weighted average approach as it will properly take account of the cost of new borrowings expected to be undertaken at the start of each regulatory period based on the approved capex forecasts. The application of a weighted average is not unreasonably complex and would be fully transparent. The AER has favoured the simple average approach because it is seen as avoiding complexity. However, the more important issue is the ongoing mismatch between the regulated cost of debt and the cost of new borrowings. Energex therefore considers that the decision regarding the averaging approach should be made having regard to this issue as a matter of policy, rather than whether one approach is more complex than the other.

In summary, Energex supports the AER's proposed introduction of the trailing average approach with annual updating. However, this should also be based on:

- A ten year term to maturity; and
- A weighted average that reflects the profile of new borrowings.

Averaging Period

Under the QTC method to transition to the trailing average portfolio approach, the allowed benchmark cost of debt in the first averaging period is the prevailing rate.

The Draft Guidelines propose for this rate to be derived from an averaging period with a starting date to be a day after the submission of a NSP's regulatory proposal and an end date no later than a month before the release of the AER's draft decision.

Where a NSP is subject to a 'preliminary determination with mandatory re-opener', this approach provides for a maximum averaging window of five months. Energex is concerned that the narrowness of this window for the derivation of the prevailing rate would limit the ability of a NSP to appropriately transition away from the 'on the day approach' and potentially expose NSPs to a significant mismatch between the regulatory cost of debt allowance and actual cost of debt.

For this reason, Energex considers that the potential first averaging period should be extended. To facilitate this Energex considers that the dates should be able to be nominated by the NSP prior to submission of their regulatory proposal, subject to the averaging period taking place in the future.

Gamma

The last issue – which is also comprehensively addressed in the ENA's submission – is the AER's proposed approach to gamma. Overall, Energex has two fundamental concerns with the AER's approach.

The first concern is the new conceptual framework that the AER has applied, which is based on its interpretation of Officer's seminal work on dividend imputation. In particular, it seeks to re-interpret 'value' as the portion of credits redeemed rather than the value that investors actually ascribe to these credits. In Energex's view, the only relevant interpretation is the value that investors ascribe to franking credits based on the extent to which they factor this in when forming their expectations of the required rate of return. This requires reference to market data.

This leads to the second main concern, being the estimation methods and data used by the AER to 'value' franking credits. Consistent with the other rate of return parameters, this needs to be informed by robust empirical analysis using market data. Measures such as the AER's equity ownership approach and tax statistics cannot be used in deriving a value for gamma because they are purely statistics, not values. Significant weight should continue to be placed on the SFG dividend drop off study, which was subject to intense scrutiny by the Australian Competition Tribunal. The updated version of this study commissioned by the ENA, as well as other evidence it submits, confirms that 0.25 currently remains the most appropriate estimate for the value of gamma.

Thank you for the opportunity to comment on the Draft Guideline. If you have any questions in relation to Energex's submission please contact Mick Ryan, Regulatory Affairs Manager – Operations on (07) 3664 4125

Yours sincerely



Neil Andersen
A/Executive General Manager
Customer and Corporate Relations