Investing in energy infrastructure

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28 June 2013

Mr Warwick Anderson
General Manger – Network Regulation Branch
Australian Energy Regulator
GPO Box 3131
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Dear Warwick

Response to Consultation Paper: Rate of Return Guidelines

Thank you for providing Envestra with the opportunity to respond to this important part of the AER Better Regulation program. The recent changes to the National Gas Rules (NGR) provide the potential for significant improvements in the way the rate of return is to be determined, including setting an objective that requires the rate of return *"to be commensurate with the efficient financing costs of a benchmark efficient entity with a similar degree of risk as that which applies to the Service Provider*".

We have participated in the development of and support the positions put in the submissions made to the AER by the Financial Investor Group and the Energy Networks Association. The submission attached to this letter sets out Envestra's views on some of the key issues raised in the Consultation Paper, including that the:

- Guidelines developed by the AER should focus on setting out the approach that is intended to be taken by the AER to determine the rate of return rather than setting the specific parameters used to determine the cost of equity and debt;

- NGR require the AER in determining the rate of return to have regard to relevant estimation methods, financial models, market data and other evidence, rather than necessarily apply the standard AER approach (which approach, and subsequent appeal activity, contributed to the review of the NGR);

- with regard to the cost of equity, a consideration by the AER and stakeholders of a broader range of information, including market practice as set out in Independent Expert Reports, is appropriate given the inherent issues associated with each individual approach on its own, thereby leading to a cost of equity that is commensurate with benchmark efficient costs;

- with regard to the cost of debt, the large debt requirements and long life of the assets has led industry towards staggering its debt maturities over time, making the trailing average portfolio approach the most logical basis to setting the cost of debt;

- the resultant cost of debt should be updated annually to more closely align the cost of debt with benchmark efficient financing costs and to mitigate the impact of unexpected events occurring over the regulatory period; and

- the long life of the assets being financed makes it obvious that a 10 year term is an appropriate basis for setting the cost of debt and equity, which position is supported by market/industry practice and the views of many stakeholders (most recently the Productivity Commission in its inquiry into Electricity Networks Regulatory Frameworks).

These issues are explained in more detail in the submission attached to this letter.

We look forward to further participating in this important consultation process through to the completion of the first rate of return Guideline to be released towards the end of this year. Please contact Craig de Laine (08 8418 1129) at anytime to arrange a time to discuss this matter further.

Yours Sincerely

Ian Little
Managing Director

Envestra Response to AER Rate of Return Consultation Paper

June 2013

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1. Introduction

1.1. Acronyms

A series of acronyms are used throughout this report. Unless otherwise stated these acronyms have the meaning listed in the following table:

AEMC	Australian Energy Market Commission
AER	Australian Energy Regulator
CAPM	Capital Asset Pricing Model
CGS	Commonwealth Government Security
ENA	Energy Networks Association
GNSP	Gas Network Service Providers
IER	Independent Expert Reports
NGL	National Gas Law
NGO	National Gas Objective
NGR	National Gas Rules

2. Structure of Response

Envestra is pleased to submit this response to the AER's Rate of Return Guideline Consultation Paper, dated May 2013. Envestra's response comprises two parts:

1. General comments; and

2. Specific comments on the questions and issues raised in the AER submission.

3. General Comments

3.1. Background

The new National Gas Rules (NGR) requires the Australian Energy Regulatory (AER) to develop a non-binding Rate of Return Guideline(s) that sets out the approach that is intended to be taken by the AER to determine the allowed rate of return for natural gas and electricity distribution and transmission service providers.

Consistent with the NGR, the AER has advised that it intends the final guideline to include sufficient detail to allow stakeholders to make a reasonably good estimate of the rate of return that would be determined by the AER if the guideline(s) were applied to a determination for a particular business at any given time.

The AER has advised that it will complete and publish the guidelines by 29 November 2013. Once completed, the AER intends to apply the Guideline(s) to the next round of regulatory determinations that are submitted to the AER from May 2014. The AER has issued a Consultation Paper and stakeholders have been invited to make submissions to the AER on this paper.

Envestra welcomes the opportunity to submit these comments on the Consultation Paper and the issues raised by the AER. Envestra notes that it also supports the positions put forward in the submissions made by both Energy Networks Association (ENA) and Financial Investor Group on the Consultation Paper, both of which Envestra participated in developing.

3.2. General Comments on Guidelines

3.2.1. Need for adequate incentive

Envestra submits that:

- the regulatory framework must deliver incentives that are comparable to the incentives experienced by firms in the economy at large, whether regulated or not. Failure to deliver such incentives will put at risk the long term interests of consumers via the reduced availability of capital, which will ultimately have implications for the reliability of natural gas supplies;

- inconsistent incentives could lead to a distorted capital allocation between industries, which would reduce economic efficiency; and

- incentives must be adequate to ensure efficient performance of the gas network service providers (GNSPs), including capital investment and financing activities.

3.2.2. Need for openness and transparency

It is important that there is a high level of transparency throughout the AER's decision making processes, including in the rate of return guideline itself, so as to encourage efficient communication between the AER and stakeholders in order to provide confidence to investors and consumers.

3.2.3. Need for rigorous and practical approach to rate of return determinations using auditable evidence

The Consultation Paper at page 30 states:

> *"We intend to use the* ***[Criteria]*** *to set out in the [final] guideline the estimation methods, financial models, market data and other evidence relevant to establishing the allowed rate of return...The criteria are:*
>
> *The allowed rate of return objective may be best met if the proposed rate of return methodologies are:*

- where applicable, reflective of economic and finance principles and market information
  - estimation methods and financial models are consistent with well-accepted economic and finance principles and informed by sound empirical analysis and robust data;
- fit for purpose;
  - use of estimation methods, financial models, market data and other evidence should be consistent with the original purpose for which it was compiled and have regard to the limitations of that purpose;
  - promote simple over complex approaches where appropriate;
- implemented in accordance with good practice;
  - supported by robust, transparent and replicable analysis that is derived from available, credible datasets;
- where models of the return on equity and debt are used these are;
  - based on quantitative modelling that is sufficiently robust as to not be unduly sensitive to errors in inputs estimation
  - based on quantitative modelling which avoids arbitrary filtering or adjustment of data, which does not have a sound rationale;
- where market data and other information is used, this information is
  - credible and verifiable
  - comparable and timely
  - clearly sourced
- sufficiently flexible as to allow changing market conditions and new information to be reflected in regulatory outcomes, as appropriate."

While some of the above Criteria, when read at a 'high level', appear to be reasonable, Envestra notes that they have no basis in the NGL and NGR and cannot be given primacy over the statutory obligations the AER is required to discharge. The main concerns Envestra has with the proposed Criteria are:

- They could be used/applied unreasonably so as to preclude the use of relevant estimation methods, financial models and market data, particularly practitioner information. With regard to the latter, the practical application of theory by market practitioners addresses the short-falls inherent in all of the asset pricing models (such as the CAPM) and provides valuable guidance to the AER in determining the best estimate of the rate of return in accordance with rule 87 of the NGR. Independent Expert Reports (IERs) are a valuable source of this information due to the transactions that they relate to and the legal requirements and prudential obligations that must be complied with in producing such reports; and

- Preferences for simple approaches could produce less desirable outcomes than more complex, but well understood, approaches that provide outcomes that satisfy NGR requirements.

Envestra wishes to highlight the need for rigorous and objective analysis and reasoning, utilising an appropriate fact base, and for this process to be adequately documented and justified by the AER to facilitate confidence from all stakeholders, including investors. Clear, auditable and well reasoned explanations should be provided throughout the process and set out in the final guideline.

3.2.4. Need to consider a full range of evidence

Under the new rules Envestra notes that the AER "must have regard to the full range of relevant methods, financial models, market data and other evidence".

Envestra submits that the AER must ensure a full range of evidence is used to support objective, auditable decision making processes. Such evidence should include, but is not limited to, the approach and analysis undertaken by investors and advisors in IERs supporting comparable corporate and other transactions. In relation to the approach used in IER processes, Envestra submits advice by independent advisory firm Core Energy Group (Attachment 1), noting the common aspects that both the regulatory regime and the framework IERs operate within:

The environment, within which IERs are developed, issued and relied upon, has a number of similarities to the environment within which Access Arrangements are governed, managed and administered including but not limited to:

- *underpinned by a formal legal framework;*
- *set of clear guidelines to be followed;*
- *results influence major commercial outcomes with significant implications for multiple stakeholders;*
- *utilise complex information and advanced methods, tools and techniques to make value, revenue, tariffs and other financial assessment; and*
- *formal, generally public reporting which is subject to broad-based stakeholder scrutiny.*

4. Response to Specific Questions and Issues

4.1. Application of criteria for assessing rate of return

Question 3.1

Do stakeholders agree with our proposition that we should continue to determine the rate of return by ultimately selecting point estimates (possibly from within ranges) of the return on equity, the return on debt, and gearing?

The NGR requires the AER to have regard to a wide set of data, models and methods and other evidence. Specifically rule 87 of the NGR states:

"Rate of Return

(5) In determining the allowed rate of return, regard must be had to:

(a) relevant estimation methods, financial models, market data and other evidence;
(b) the desirability of using an approach that leads to the consistent application of any estimates of financial parameters that are relevant to the estimates of, and that are common to, the return on equity and the return on debt; and
(c) any interrelationships between estimates of financial parameters that are relevant to the estimates of the return on equity and the return on debt."

Envestra agrees that it is reasonable to select point estimates (from within ranges) of the return on equity, the return on debt, and gearing, so long as these point estimates are informed by a careful consideration of market circumstances, all available financial models, estimation methods and other data/evidence as required by the NGR. In light of the widely accepted understanding of the uncertainty associated with determining such ranges and point estimates, Envestra seeks further definition of how the AER will determine point estimates in practice, to ensure that uncertainty associated with specific financial parameters are adequately considered.

What is most important in achieving the requirements of the NGL and NGR is that the overall rate of return is within the range of market evidence, particularly applied market evidence such as that set out in IERs. The AER would need to provide clear reasoning if the regulated rate of return was not within such a range of market evidence, including reasons as to why the rate of return might lie within the lower or upper bounds of the range.

Objective, robust and auditable practices are necessary to provide confidence in the AER's decision making and discretionary powers, for both consumers and investors, and to ensure compliance with the revised NGR and to limit potential future appeal activity (in contrast to observed behaviour in the period following the AER's 2009 WACC review)

Question 3.2

What is the appropriate term for the return on equity? Do stakeholders support Lally's recommendation based on the present value principle that the appropriate term should be consistent with the regulatory period?

Envestra believes that a ten year term is appropriate for deriving a return on equity, on the following basis:

- Energy distribution/transmission assets are long-lived, with economic lives extending up to 60 years in most AER determinations. The appropriate term for the rate of return should, in theory, match the economic life of those assets; and

- IERs, which are governed by strict guidelines, Corporations Law and Securities Law (refer Attachment 1), most commonly use a 10-year CGS yield as the proxy for the risk free rate in the CAPM to determine the return on equity. Indeed, commercial practice was the main reason for the The Australian Competition Tribunal (GasNet 2003) rejecting the 5-year risk free rate proposed by the ACCC and determining that a 10-year term for the risk free rate was appropriate for use in the CAPM.

Envestra does not accept that Lally's recommendation is reasonable for the following reasons:

- The present value principle has no basis in the NGR, the broader energy market legislative framework or any similar framework that Envestra is aware of;

- Any positive or negative increments to allowed revenue flowing from the efficiency carryover mechanism will result in the NPV of revenues being greater or less than zero, thereby violating the AER's NPV=0 objective;

- The present value principle is not applied in commercial practice and thus has a foundation in theory alone, albeit tenuous;

- IERs do not apply the present value principle in discharging their statutory and commercial obligations, providing no practical justification for its application for regulatory purposes; and

- The present value principle has no consideration/relevance to the objective of ensuring that rate of return "*is to be commensurate with the efficient financing costs of a benchmark efficient entity with a similar degree of risk as that which applies to the Service Provider*".

Question 3.3

What is the appropriate term for the return on debt? Do stakeholders agree with the view that a specific term is not required, if we apply an approach that is similar to the ERA's 'bond-yield approach'? Is there a case for the same term for the return on equity and return on debt?

Envestra has a policy of maintaining an average term to maturity of at least 10 years for its debt portfolio with a view to prudently managing refinancing risk. Envestra considers that this approach is consistent with broader industry practice for businesses that manage long life assets, and as such, believes that a ten-year term is appropriate for deriving a trailing average return on debt.

A specific benchmark term for debt and credit rating are required for the AER to estimate the appropriate benchmark return on debt. Further, the benchmark term of debt issue should reflect the industry practice observed for firms that are comparable to the benchmark GNSP. To this end, the Productivity Commission in its inquiry into Electricity Networks Regulatory Frameworks has endorsed the use of a 10 year trailing average to set the cost of debt. Specifically, the Productivity Commission (pg. 29) in this report, which was released on 26 June 2013, notes that:

> *"...the AER consider using a long-term trailing average to estimate the debt risk premium and the risk-free rate. Averages taken over a longer period are more stable predictors of market conditions and are more likely to represent the actual borrowing patterns of the firms involved, as no firm would normally roll over its entire debt portfolio in a two-week period every five years.*

This same principle is also highly relevant to the AER considerations in regard to the term of the cost of equity. Envestra does not accept that ERA's 'bond-yield approach' provides a reasonable basis for proposing that a specific term for return on debt is not required, on the basis that the ERAs "bond yield" approach has a number of inherent flaws. For example, the non-specific debt issuance term and credit rating will not match the efficient benchmark and there is little prospect that the actual costs of financing regulated energy networks with 10-year debt will be recovered in the regulatory rate of return. These flaws make the ERA approach inconsistent with the NGR/NER and inappropriate for use by the AER.

Question 3.4

For parameter estimates, should we adopt point estimates, ranges, or point estimates from within a range?

Consistent with the response to Question 3.1, Envestra believes that point estimates need to be adopted from within a range that has been informed from a number of estimation methods, financial models and market data. Further, in selecting a point from within a range, the reasoning needs to be rigorous, objective and auditable. As already noted, any approach that is based on a broad range of information, as required by the NGR, should lead to an overall rate of return that is commensurate with benchmark efficient finance costs, although this needs to be checked against relevant market data.

Question 3.5

At what stage (during a determination or the guidelines process) should point estimates or ranges of the return on equity, return on debt and parameter estimates, be established?

Envestra submits that any approach that seeks to pre-specify point estimates, ranges and/or weightings of evidence in advance of a defined assessment date is impractical, inflexible and inconsistent with the intention of the new NGR, as the AER needs to consider a range that is relevant to the current market conditions. This is because market conditions can change suddenly and significantly, which was demonstrated on many occasions over the last five years (and beyond).

It is imperative that market conditions and all other relevant evidence is considered at the date of the assessment and not prior thereto. The best objective evidence of market conditions at a point in time can be derived from IERs, which information needs to be incorporated into the AER decision making process.

Question 3.6

Should we make annual adjustments to the return on debt?

There are three broad methodologies available under the Rules for determining the return on debt:

1. On the day approach – which reflects the return that would be required by debt investors if all debt was raised shortly before the commencement of the regulatory period (which is the current approach);

2. Trailing average portfolio approach – which reflects the return required by debt investors if debt was raised over a historical period; or

3. Hybrid approach – which is a combination of the above two approached.

By definition, the "on the day" approach does not require any annual adjustment.

The trailing average, comprised of 10 year fixed rate corporate bonds (with the benchmark credit rating), each with one-tenth weight in the averaging process, requires an annual adjustment mechanism to facilitate smooth price transitions and hedgability of the GNSPs debt portfolio in-line with the benchmark. Reduced price volatility and the ability to reflect market conditions over a regulatory period are the major consumer benefits of a trailing average portfolio approach that is updated annually over the regulatory period.

4.2. Benchmark Firm and Compensation for Risk

Question 4.1

Set out the risk factors that you consider should be compensated through the rate of return. How can we assess whether different companies are exposed to materially different degrees of these risks?

Envestra submits that there are many risks, some unknown risks, that cannot be quantified and incorporated into cash flow forecasts. These risks need to be compensated through the rate of return, with market practices considered from IERs. Gas and electricity networks have different risks, which are derived from the fundamentally different physical characteristics of each form of energy and the different consumer demand profiles.

Importantly, gas is a fuel of choice whereas electricity is a necessity, and to the extent these risks cannot be compensated for in the cash flows, they need to be accounted for in the regulatory rate of return. To this end, the AEMC anticipated in its Final Rule Determination (pp. iii and 67) that a "one size fits all" approach is not appropriate across the entire energy sector. The AEMC noted that:

> *"the objective is focussed on the rate of return required by the benchmark efficient service provider, with similar risks as the service provider the subject of discussion";*

And:

> *"the [allowable rate of return objective] incorporates the concept of a benchmark efficient service provider, which means that the regulator can conclude that the risk characteristics of the benchmark efficient service provider are not the same for all service providers across the electricity transmission, electricity distribution and gas /or within those sectors"*

There is no doubt that the gas sector has a far greater element of risk relative to the electricity sector. Envestra contends that the risk faced by Envestra are akin to the risk assumed by firms operating in a competitive market more generally. This reflects that the decision to connect to gas, including at the individual appliance level, is discretionary and weighed against substitute energy sources and applications.

Another risk common to all regulated energy businesses is Regulatory Risk. Changes in regulations, rules, methodologies create uncertainty that affects investors confidence (both debt and equity) in the regulatory regime. This causes increased rate of return requirements. These issues were highlighted by Moody's Investor Service in the recent rating downgrade of Powercor from A3 to Baa1 (the S&P equivalent of a move from A- to Baa1). Amongst the reasons for the downgrade, and continued negative outlook, given by Moody's were:

> *"....the sector as a whole faces increased regulatory risk due to uncertainty associated with the rule changes enacted by the Australian Energy Market Commission in November 2012."*

And:

> *".....the rating could also face downward pressure if there is a material shift in the regulated return setting philosophy, to be outlined in the rate of return guidelines by the regulator, expected to be released in November 2013."*[1]

This reflects, among other things, the decision made to change the NGR within a period of five years from when those rules were first implemented.

Question 4.2

Do different return on equity models account for systematic risk differently, or do they also account for non-systematic risk? If the latter, is it appropriate for the AER to set allowances that remunerate risks that could be diversified away from?

This is a broad and complex issue and Envestra supports the detailed submission by the ENA to the AER Consultation Paper.

Question 4.3

Do you agree that the AER should seek to utilise the smallest number of benchmarks that capture materially different degrees of risk? How do we utilise different benchmarks while retaining the objectives of incentive-based regulation?

Envestra submits that consideration must be given to an appropriate range of benchmarks that capture materially different degrees of risk and that it is not appropriate to simply focus on a "small" number as proposed. The appropriate compensation for risk through the regulatory rate of return will, of itself, provide incentives for network businesses.

4.3. Return on Equity

Question 5.1

Which of the four broad approaches to combining information to determine a return on equity is preferred and why? Are there additional broad approaches that we should consider?

An approach that considers all relevant estimation methods, financial models, IERs, market data and other evidence, and which gives appropriate weight to each piece of evidence based on all available information, is the only option that will achieve the overall rate of return objective set out in the NGR. Envestra therefore submits that approaches (1) to (3) set out in the Consultation Paper are either inconsistent with the NGR, and as such, inconsistent with the intention of the AEMC.

If the AER uses one primary model with reasonableness checks, which Envestra considers is inconsistent with the NGR, then this is similar in nature to the current approach adopted by the AER (i.e. the same approach is applied despite the Rules having changed). History has shown this approach to be inadequate. For example, reasonableness checks, including that undertaken by the AER, have indicated that the AER assessed cost of equity is too low, but this has not resulted in a revision of the AER's assessment.

Further, some of the reasonableness checks used by the AER to date have been unreasonable or ineffective. For example, outdated RAB multiples associated with historical transactions/acquisitions have been used by the AER to support an assessment of WACC. In one case Envestra advised the AER that its observations on the Wagga network RAB multiple were incorrect, but the AER disregarded the information:

[1] Moody's Investor Service, Rating Action: Moody's lowers Powercor's rating to Baa1; Outlook negative, 17 June 2013.

> *The AER used the recent purchase of Country Energy's NSW gas network by Envestra as a recent example of regulated energy networks being purchased at premiums to RAB. The AER used information contained in Envestra's ASX announcement dated 26 October 2010 to incorrectly conclude that:*
>
> *Envestra purchased the Wagga Wagga gas network at a 25 per cent premium to the 2010 RAB and 19 per cent premium to the 2011 RAB.*
>
> *The purchase price of $107 million is not materially different to the Wagga Wagga gas networks RAB of $60.8 million at 31 October 2010 plus Non-regulated book value of the assets of $44.4 million ($105.2 million). Furthermore, two other key points were made in the Envestra ASX announcement: (i) the business was acquired using 61% debt and (ii) the discount rate used in the valuation was consistent with the rate of return submitted for the South Australian and Queensland Access Arrangement review in October 2010. These facts do not support the AERs observation that regulated cost of capital has been in excess of the actual cost of capital as the purchase price and capital structure were in line with the regulatory benchmarks; and the discount rate was consistent with that proposed in our October Revision*[2].

That aside, RAB multiples are not an effective way to make judgements of the rate of return given the myriad of factors explaining such multiples.

The Consultation Paper has not provided any information about how these inconsistencies will be satisfactorily addressed and resolved in the future.

Envestra therefore has the view that the fourth approach is most appropriate as it allows for a consideration of the broadest range of available financial models, estimation methods and market data, and as such, is the only option available under the new NGR. This approach has the advantage of providing the necessary flexibility to adjust the rate of return should changes in market conditions warrant such an adjustment.

Importantly. the AER will need to support this approach with detailed reasoning explaining why and how judgement has been used in order to meet the requirements of the NGR, particularly the rate of return objective.

Question 5.2

How can the various information sources relevant to estimating the return on equity be brought together transparently?

Envestra submits that transparency requires the regulator to clearly:

- set out all evidence it has considered, including the basis for rejecting any evidence;
- explain how it has arrived at each parameter point estimate within a defined range; and
- define the weights that it has assigned to each financial model together with an explanation of the basis for assigning such weights, including how such weights ensure a rate of return that is *"commensurate with the efficient financing costs of a benchmark efficient entity with a similar degree of risk as that which applies to the service provider in respect of the provision of reference services."*.

[2] Envestra, South Australian revised Access Arrangement, Attachment 9-10 Other Rate of return Issues, March 2011.

Question 5.3

Do stakeholders agree with our preliminary position that it is not feasible to change the weights placed on different return on equity models (over time) based on differing market conditions, industry segments or firms?

Envestra submits that any approach that seeks to pre-specify weights in advance of a defined assessment date is impractical, inflexible and inconsistent with the intention of the new NGR. Market conditions can change suddenly and significantly as demonstrated on many occasions over the last five years (and beyond). It is imperative that market conditions and all other relevant evidence is considered at the date of the assessment and not prior thereto.

Question 5.4

What are the benefits of using financial models to estimate the return on equity for an average firm before estimating it for the benchmark firm?

Estimating the return on equity for the "average" firm using a variety of information, consistent with the NGR, will help the AER calibrate its estimate prior to determining the return on equity for the benchmark firm. This will remedy the material errors that were evident from previous AER decisions and its application of the CAPM under the old NGR, thereby reducing the potential for appeal activity over the life of the Guideline.

Envestra, and the other Victorian gas businesses, highlighted some technical flaws in the AERs application of the CAPM in their responses to the draft Victorian decision[3]. This evidence demonstrated that, in applying the CAPM, the AER incorrectly combined a short term average of the risk free rate with a long term average of the market risk premium. The consistent use of the CAPM requires that either long term or short term parameters are used, which is consistent with finance theory and the application of the CAPM by many other regulatory authorities, including the OFGEM in the United Kingdom and IPART in Australia.

The proper application of the CAPM is also consistent with the criteria developed by the AER, including that the rate of return methodologies are:

- where applicable, reflective of economic and finance principles and market information (particularly that finance models are consistent with well-accepted finance principles);
- implemented in accordance with good practice; and
- where models of the return on equity and debt are used these are based on quantitative modelling that is sufficiently robust as to not be unduly sensitive to errors in input estimations.

Envestra took the view that it was more appropriate to remedy this aspect of the AER Victorian Final Decision as part of the AER guideline development process rather than through the Australian Competition Tribunal. These shortcomings should be recognised and incorporated into the AERs methodology and Guideline.

[3] Envestra, Revised Victorian Access Arrangement Information, Attachments 9.13, 9.14, 9.15, 9.16 and 9.17, 9 November 2012

4.4. Return on Debt

Question 6.1

Do you support our proposal of having a single approach for estimating the return on debt should be used for the definition of the benchmark efficient entity (or for each definition, if more than one benchmark is used)?

Envestra submits that the cost of debt could be estimated either by reference to an estimate developed by a third-party data source (such as Bloomberg), or by collecting as wide a range of yield data as possible and fitting curves through that data using econometric techniques that use all the relevant information and are capable of distinguishing the impact of credit rating and term to maturity at issuance on bond yield. PricewaterhouseCoopers outlined an econometric regression methodology for estimating the benchmark debt risk premium in their report for the Victorian gas network businesses in March 2012[4]. PricewaterhouseCoopers found the debt risk premium calculated using the extrapolated Bloomberg BBB fair value curve was a close fit for the econometrically estimated debt risk premium, thereby supporting the Bloomberg debt risk premium estimates.

Envestra supports the continual use of Bloomberg given the complexity of constructing yield curves from the available market data. Bloomberg provides an independent and expert view of the cost of debt based on all available market data.

Question 6.2

How do the "on the day" approach, trailing average portfolio approach, and hybrid approach to estimating the return on debt compare in terms of promoting efficiency?

Envestra notes that the AER has previously stated that in the long-run, the trailing average and "on the day" approaches provide an equivalent (or at least similar) outcome. In short, Envestra is supportive of the trailing average portfolio approach (with automatic annual adjustments) based on the cost of debt measured over a historical 10 year period. Envestra considers that such an approach will most closely resemble the efficient financing practices of businesses that manage long life assets such as gas distribution networks.

Question 6.3

What are the considerations that we should have when setting the gearing level?

The AER needs to consider empirical evidence relating to gearing, including but not limited to, the costs and risks associated with higher gearing, and the interrelationships between the return on equity and credit rating. Most importantly, the AER should pay careful attention to credit rating agencies' expectations for gearing for the "benchmark efficient entity".

[4] Envestra, Victorian Access Arrangement Information, Attachment 9.7, March2012

4.5. Imputation Credits

Question 7.1

Should we still estimate gamma as an economy wide measure? Alternatively, should we seek to narrow the gamma benchmark? If so, what is a more appropriate benchmark?

The value of gamma for use in regulatory decisions has been the subject of significant debate over a long period of time, which is often highly theoretical and esoteric. The practices of independent experts provides an excellent source of relevant information, in terms of market practice, that can be applied simply by the AER.

Envestra submits that a value of zero is the best estimate of gamma for use by the AER. This is consistent with the approach widely adopted by IERs and commercial enterprises, for businesses comparable to the GNSP (e.g. HDUF (2012) and Alinta (2007)) over a long period of time.

Question 7.2

To what extent do stakeholders support the use of a definitive source of evidence, even where it has demonstrable shortcomings? Alternatively, to what extent do stakeholders support the use of a wider range of evidence, having regard to its strengths and weaknesses?

The use of a definitive source of evidence with demonstrable shortcomings (based on rigorous assessment) should not be used if such shortcomings result in materially distorted outcomes. Consistent with the NGR, Envestra recommends the use of range of appropriate evidence, having regard to specific strengths and weaknesses with a view to all evidence being considered in informing a final assessment.

4.6. Debt and Equity Raising Costs

Question 8.1

Do you support our preliminary position of not setting a specific allowance for debt and equity raising costs, and instead, remunerating them elsewhere in the revenue building blocks?

Envestra does not support the AERs preliminary position. Debt and equity raising costs can be material and need to be objectively and transparently determined and incorporated into the building blocks. This is consistent with the requirements of the NGR.

4.7. Forecast Inflation

Question 9.1

Should we continue to use our current approach to forecast inflation or move back to using the Fisher equation? Alternatively, should the AER use inflation swaps? Are there other approaches not identified in this paper that we should consider?

The AER current approach has not produced inflation forecasts with any systematic biases and should therefore continue to be used.

4.8. Return on Debt and Gearing

Question G.1

How should we address the issues regarding annual updating of the return on debt estimate?

Annual updating of the cost of debt in the trailing average approach is necessary for GNSPs to be able to match the benchmark and hedge the interest rate risk embedded in the regulatory rate of return. The approach to updating the cost of debt will need to be specified in the Access Arrangement and be capable of occurring automatically as part of the annual tariff review and approval process.

Question G.2

What should be our considerations when deciding whether transition between benchmarks is required? How should we apply transition while retaining the properties of incentive-based regulation?

Envestra supports the detailed submission by the ENA to the AER Consultation Paper. Envestra has maintained an average debt maturity of 10 years for a number of years, such that no transition would be required to implement the 10 year trailing average approach.

Question G.3

To what extent does the estimation method need to incorporate the different types of debt available to a business in order to be consistent with the Rate of Return Objective?

Envestra supports the detailed submission by the ENA to the AER Consultation Paper. Envestra notes that any decision to broaden the types of debt included in the estimation method would increase the level of judgement/subjectivity of a decision.

Question G.4

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?

The cost of debt could be estimated either by reference to an estimate developed by a third-party data source (such as Bloomberg), or by collecting as wide a range of yield data as possible and fitting curves through that data using econometric techniques that use all the relevant information and are capable of distinguishing the impact of credit rating and maturity on bond yield. As noted earlier, Envestra supports the continual use of Bloomberg given it provides an expert and independent analysis of the available market data.

Question G.5

When selecting bonds for use in the estimation—either in an AER-developed dataset or a third-party dataset—what should be our selection considerations in terms of maturity, credit rating, industry sector and country of issuance?

In the absence of Bloomberg, a broad range of information should be used to derive the benchmark term of issuance and credit rating.

Question G.6

Do you support our proposed methodology for determining the gearing level?

Envestra supports the ENA position on this issue.

28 June, 2013

Mr. G Meredith
Group Manager - Treasury and Planning
Envestra Limited
81 Finders Street
ADELAIDE S.A. 5000

Dear Mr. Meredith,

Introduction and Scope

Core Energy Group (Core)[1] has been engaged by Envestra Limited (Envestra or the Company) to provide an expert opinion on the following:

- role of Independent Expert Reports ("**IER**");
- the approach and practices followed by Experts in preparing IER's as they relate to the AER's Consultation Paper; and
- an independent view on whether IER's provide useful evidence in AER regulatory assessments of the kind addressed by the AER Consultation Paper.

This report is to form part of the Company's submission to the Australian Energy Regulator (AER) in relation to the Rate of Return Guideline Consultation Paper.

Role of an IER - Legal and Commercial Basis

In general terms, IER's are issued in compliance with the Corporations Act 2001 ("**Corporations Act**"), in order to provide security holders with an independent, expert opinion in relation to a specific Transaction, involving one or more companies or entities. More specifically, the IERs provide an opinion on whether a proposed transaction is 'fair and reasonable' and / or 'in the best interest' of security holders. Further, an IER is often voluntarily commissioned by a Board of Directors of a Target company, or in some cases the counterparty, in order to provide security holders with the benefit of an independent assessment of the whole or part of a proposed transaction.

In this context, Transactions include, but are not limited to - takeovers, mergers, schemes of arrangement, related party transactions, security buy-backs, acquisitions and divestments.

[1] Core Energy is holder of AFSL 307740 and provides Independent Expert advice and IER's to Wholesale investors.

Independent Experts operating under the Corporations Act must hold an appropriate Australian Financial Services Licence and prepare the IER in compliance with an explicit governance regime, comprising both statutory rules and practice guidelines[2].

The environment, within which IERs are developed, issued and relied upon, has a number of similarities to the environment within which Access Arrangements are governed, managed and administered including but not limited to:

- underpinned by a formal legal framework;
- set of clear guidelines to be followed;
- results influence major commercial outcomes with significant implications for multiple stakeholders;
- utilise complex information and advanced methods, tools and techniques to make value, revenue, tariffs and other financial assessment; and
- formal, generally public reporting which is subject to broad-based stakeholder scrutiny.
- A more detailed listing of the legal and regulatory framework which applies to IER's is included as Annexure 1.

However an expert preparing an IER faces additional disciplines and risks to the risks of experts preparing submissions for Access Arrangements. Firstly as the IERs are relied upon by shareholders and other decision makers the expert preparing an IER faces the risk of negligence actions by shareholders and other decision makers if the report is not prepared with reasonable care. Secondly there is the risk of claims for misleading and deceptive conduct if a report is inaccurate (and noting such claims do not even have the threshold that there must have been a want of care before the claim can be brought). The practical risks of these claims has been increased markedly in the last few years with the increasing prevalence of class actions.

As noted in ASIC's Regulatory Guide 111:

> *"An expert should use its skill and judgment to select the most appropriate methodology or methodologies in its report... The expert must have a reasonable (or tenable) basis for choosing its valuation methodologies…An inappropriate choice might be misleading…It might also lead to liability because the expert did not take sufficient care and skill in the preparation of the report."*[3]

And

[2] Independent Experts and IERs are regulated by ASIC - Regulatory Guide 111: Content of expert reports and Regulatory Guide 112: Independence of experts.

[3] Paragraph RG 111.64.

> *"An expert's opinion should be based on reasonable assumptions. This reduces the risk that the report will be misleading."*[4]

And quoting Santow J in *Re Australian Co-operative Foods Ltd* (2001) 38 ACSR 71:

> *"Experts are responsible for what they say in their reports. They must ensure that their reports deal adequately with the kind of concerns that could reasonably be anticipated from those affected by the scheme, in reporting on whether the relevant scheme proposal is fair and reasonable from their viewpoint."*[5]

And

> *"An expert cannot limit its statutory liability for the report through disclaimers (e.g. that the expert will not be liable for any loss incurred through reliance on its report). An expert report that purports to exclude the expert from liability may be misleading."*[6]

And

> *"ASIC expects an expert preparing an expert report to be, in fact, an expert in the relevant field."*[7]

Further as noted in ASIC's Regulatory Guide 111 where there are material issues with an expert report (that is as to the adequacy or completeness of the expert's analysis) ASIC may take a number of steps. These include action for contravention of misleading or deceptive conduct provisions, action to revoke or suspend the expert's licence or action to cease or suspend nominating the expert to prepare reports in compulsory acquisitions.

Therefore the requirements of the *Corporations Act 2001*, *Australian Securities and Investments Commission Act 2001* and the ASIC regulatory guidelines are real disciplines with which an expert must comply to ensure their reports do not expose them to personal risks.

As noted in the ASIC Regulatory Guide 1111, "expert reports typically constitute the giving of financial product advice so an expert must hold an Australian financial services (AFS) licence"[8]. Further where an expert holds a financial services licence they are required to comply with the requirements of section 912A of the *Corporations Act 2001*. These include that they must:

- do all things necessary to ensure that the financial services covered by their licence are provided efficiently, honestly and fairly (section 912A(1)(a));
- maintain the competence to provide financial services (section 912A(1)((e));
- ensure their representatives are adequately trained, and are competent, to provide financial services (section 912A(1)(f));
- have adequate risk management systems (section 912A(1)(h)).

[4] Paragraph RG 111.74

[5] Paragraph RG 111.85

[6] Paragraph RG 111.107

[7] Paragraph RG 111.117

[8] Paragraph RG 111.120.

Approach to Valuation

IERs generally incorporate a valuation assessment regarding the asset(s), company(s) or security(s) or other item which is the subject of the IER. Based on Core's experience, these valuation assessments have a range of features in common:

- practitioners are generally highly experienced and trained professionals with many years of specific experience in providing expert, independent valuation opinion on simple and complex transactions;
- practitioners generally have an intimate knowledge of world's best practice in the field of valuation, including factors to be considered in arriving at a rigorous assessment of rate of return (including cost of debt, cost of equity), gearing, risk and uncertainty and other core elements of a valuation assessment and finer issues such as value of imputation credits;
- more than one valuation methodology is generally considered, and the results are compared and analysed, in arriving at a final valuation assessment and opinion[9];
- any emphasis placed on one methodology over another varies between transactions, based on the quality of information available as a basis for the valuation assessment;
- IER valuations generally reflect market conditions at the time the IER is undertaken. Experience and expertise is used to assess capital and other market conditions and to derive a rate of return on debt and equity that is required by investors, having regard to risk tolerances;
- a significant degree of emphasis is placed on an assessment of an appropriate rate of return or discount rate to be applied, based on a rigorous analysis of the features of the entity being valued;
- comparator company, asset or other analysis is widely used to provide valuation insights;
- where adequate information is available, Experts will generally place significant emphasis on a discounted cash flow methodology, with discount rates (cost of equity element) determined by reference to the Capital Asset Pricing Model (CAPM).

Use of Discounted Cash flow Approaches and CAPM

For assets or companies which are similar in nature to regulatory assets, where estimates of future net cash flows can developed with an acceptable degree of certainty, a discounted cash flow method of valuation is commonly undertaken or is specifically stated to be the preferred methodology used by an Independent Expert.

Experts generally apply some form of risking factor to cash flow projections to address assessed risks and uncertainties associated with one or more underlying variables or assumptions.

Ernst & Young's "*Market Evidence on the Cost of Equity – Victorian Access Arrangement Review 2013-2017*"dated 8 November 2012[10]indicates that a total of 889 IERs were analysed over the period January 2008 to October 2012 and a total of 267 IERs included an analysis of an appropriate discount rate and 167 (63% of the 267) derived the cost of equity using the CAPM.

[9] We note ASIC Regulatory Guide 111 states that an expert should where possible use more than one valuation methodology.
[10] Including Envestra, Multinet , SP AusNet, GasNet Access Arrangements for Victoria and Envestra only for Albury.

Grant Samuel have consistently applied the CAPM in valuing utilities, such as Alinta (2007) and Hastings Diversified Utilities Fund (2012).

Cost of Debt Considerations

Core's experience is that Experts apply a rigorous, objective, observable and auditable approach to arriving at an assessment of the cost of debt. Relevant considerations include:

- generally rely on an a risk free rate, based on the yield on a 10 year Commonwealth Government security (refer Ernst & Young report);
- the reference 10 year CGS is generally observed as at the valuation date (or in the period immediately preceding it);
- a rigorous assessment is undertaken to derive the premium above the risk free rate to be applied under the specific circumstances, having regard to a wide range of evidence, including comparator or benchmark data and analysis.

Cost of Equity Considerations

Core's experience is that Experts apply a rigorous, objective, observable and auditable approach to arriving at an assessment of the cost of equity. Relevant considerations include:

- IER's which rely on cash flow based valuation approaches generally undertake rigorous analysis of a wide range of factors including but not limited to the following, in undertaking an assessment of the cost of equity:
  - risk free rate
  - market risk premium
  - beta - to measure specific volatility relative to market
  - imputation credit value - distribution rate and value
  - assessment of Specific risks and uncertainties relating to the company, asset or security.

Core View on Relevance of IERs as Evidence for Access Arrangements

Core Energy Group, in its capacity as a specialist energy advisory firm and its CEO, Mr. Paul Taliangis combine over twenty years of national and international experience in undertaking independent assessment of value of energy industry-related companies, assets and securities. This experience extends across all areas of the energy value chain at a national and international level.

Based on my own experience and that of Core Energy generally, I submit that IERs are part of the "relevant estimation methods, financial models, market data and other evidence" referred to in rule 87(5)(a) of the National Gas Rules and further should be given substantial weight. In substance, the reports deal with the same types of subject matter as is the concern of rule 87. The reports are objective and prepared as part of a highly disciplined framework where there are real and substantial risks for the reports authors if they are incorrect (as compared for example to academic reports where the risks are (at most) only reputational rather than the risk of incurring civil liability or losing the ability to operate in one's profession).

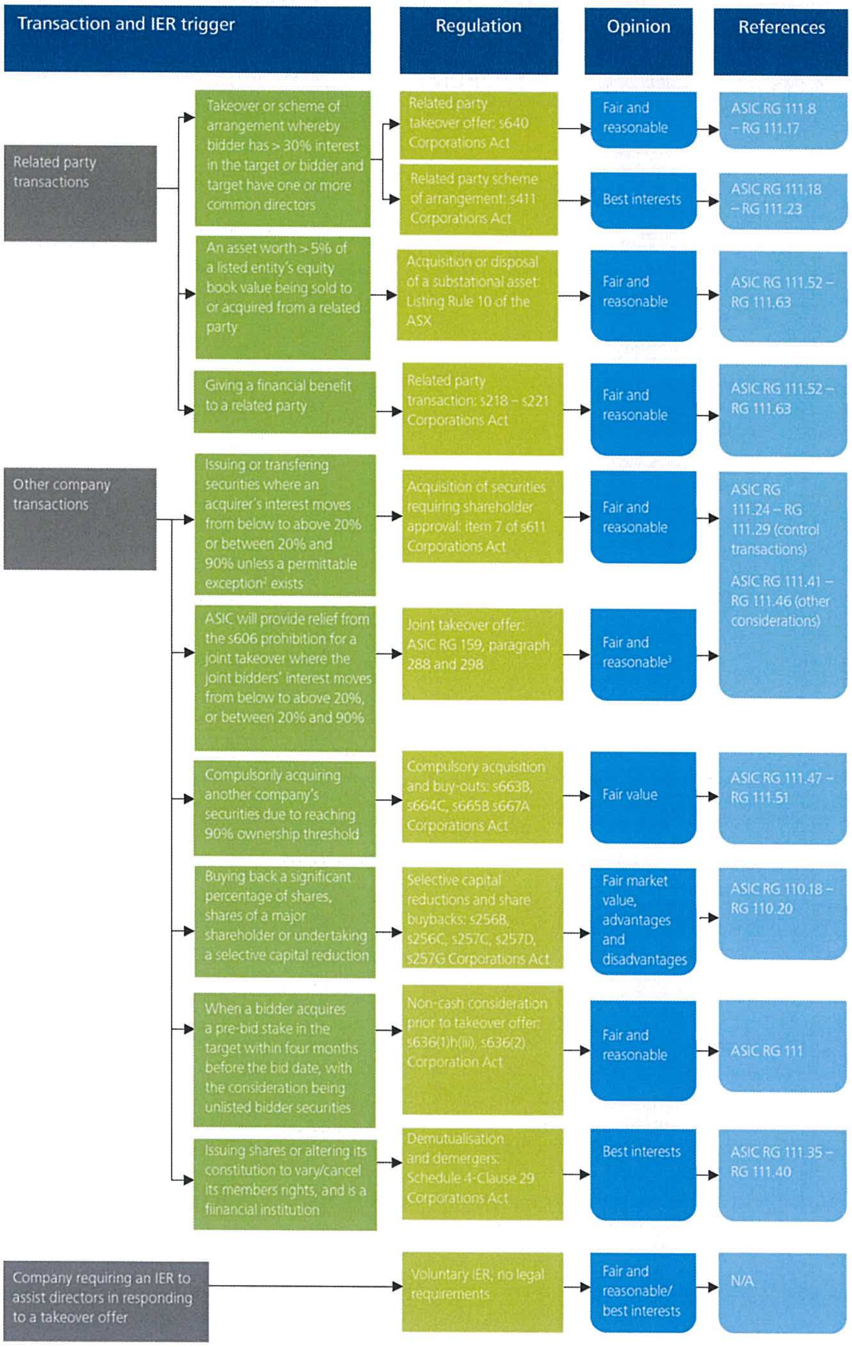
Yours sincerely,

Paul Taliangis

Chief Executive [11]

[11] Responsible Officer under Core Energy Group AFSL.

Annexure 1 – When an IER is Required



Transaction and IER trigger		Regulation	Opinion	References
Related party transactions	Takeover or scheme of arrangement whereby bidder has > 30% interest in the target *or* bidder and target have one or more common directors	Related party takeover offer: s640 Corporations Act	Fair and reasonable	ASIC RG 111.8 – RG 111.17
		Related party scheme of arrangement: s411 Corporations Act	Best interests	ASIC RG 111.18 – RG 111.23
	An asset worth > 5% of a listed entity's equity book value being sold to or acquired from a related party	Acquisition or disposal of a substational asset: Listing Rule 10 of the ASX	Fair and reasonable	ASIC RG 111.52 – RG 111.63
	Giving a financial benefit to a related party	Related party transaction: s218 – s221 Corporations Act	Fair and reasonable	ASIC RG 111.52 – RG 111.63
Other company transactions	Issuing or transfering securities where an acquirer's interest moves from below to above 20% or between 20% and 90% unless a permittable exception[2] exists	Acquisition of securities requiring shareholder approval: item 7 of s611 Corporations Act	Fair and reasonable	ASIC RG 111.24 – RG 111.29 (control transactions) ASIC RG 111.41 – RG 111.46 (other considerations)
	ASIC will provide relief from the s606 prohibition for a joint takeover where the joint bidders' interest moves from below to above 20%, or between 20% and 90%	Joint takeover offer: ASIC RG 159, paragraph 288 and 298	Fair and reasonable[3]	
	Compulsorily acquiring another company's securities due to reaching 90% ownership threshold	Compulsory acquisition and buy-outs: s663B, s664C, s665B s667A Corporations Act	Fair value	ASIC RG 111.47 – RG 111.51
	Buying back a significant percentage of shares, shares of a major shareholder or undertaking a selective capital reduction	Selective capital reductions and share buybacks: s256B, s256C, s257C, s257D, s257G Corporations Act	Fair market value, advantages and disadvantages	ASIC RG 110.18 – RG 110.20
	When a bidder acquires a pre-bid stake in the target within four months before the bid date, with the consideration being unlisted bidder securities	Non-cash consideration prior to takeover offer: s636(1)h(iii), s636(2) Corporation Act	Fair and reasonable	ASIC RG 111
	Issuing shares or altering its constitution to vary/cancel its members rights, and is a fiinancial institution	Demutualisation and demergers: Schedule 4-Clause 29 Corporations Act	Best interests	ASIC RG 111.35 – RG 111.40
Company requiring an IER to assist directors in responding to a takeover offer		Voluntary IER; no legal requirements	Fair and reasonable/ best interests	N/A

Source: "Independent Expert Reports: Are You Prepared?" Deloitte, February 2013.

Notes:

1. Chapter 6 of the Corporations Act extends this guidance to include listed managed investment schemes as well as listed bodies that are not companies.
2. Exceptions include acquisition of up to 3% in 6 month intervals (i.e. 'creep' rules), pro-rata rights issues, etc.)
3. Where existing shares are transferred (rather than issued), the expert is required to conclude whether or not the advantages outweigh the disadvantages of the transaction rather than whether the transaction is fair and reasonable.

Annexure 2 - CV for Mr. Paul Taliangis

Mr. Taliangis is Chief Executive and founder of Core Energy Group, a boutique strategic advisory firm specialising in the Australian energy industry.

Mr. Taliangis has formal qualifications in economics and accounting and is a Chartered Accountant, gained during the early stage of his career, at Price Waterhouse (now PwC).

His nearly twenty year experience in the Australian energy industry includes an eight plus year term as an executive with Santos Limited in Corporate Development, Corporate Planning and Finance and ten years as CEO of Core Energy. During this period he has undertaken hundreds of valuation and independent expert assignments for stakeholders along the entire value chain, including Governments, foreign and domestic fund managers, investors and energy companies.

In the regulated and non regulated energy infrastructure arena, Mr. Taliangis has gained extensive experience, including valuations and strategic analysis and advice relating to:

- Companies
  - APA
  - Hastings
  - Spark
  - Envestra
  - DUET
- Assets
  - Wagga gas distribution network
  - Victorian gas distribution network
  - WA gas distribution network
  - Moomba Adelaide Pipeline (MAP)
  - Eastern Gas Pipeline (EGP)
  - South West Gas Pipeline (SWQ)
  - Moomba Sydney Pipeline (MSP)
  - SEAGas Pipeline