



# **Envestra Response to AER Draft Rate of Return Guideline**

October 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:

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

## 2. Structure of Response

Envestra is pleased to submit this response to the AER's Draft Rate of Return Guideline, dated August 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. The Draft Rate of Return Guideline (Draft Guideline) was released by the AER on 30 August 2013 and stakeholders have been invited to make submissions to the AER on this paper by 11 October 2013.

The AER has advised that it will complete and publish the Final 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.

Envestra welcomes the opportunity to submit these comments on the Draft Guideline and the issues raised by the AER. Envestra also notes that it supports the positions put forward in the submission made by both Energy Networks Association (ENA), which Envestra participated in developing.

### 3.2. General Comments on Guidelines

#### 3.2.1. Need for sufficient detail to be provided in the Final Guideline

Envestra submits that:

- the Draft Guideline did not contain sufficient detail to allow network service providers 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. This is contrary to the Rules;
- The AER's analysis and preliminary views on the value of equity beta and the Market Risk Premium should have been included in the Draft Guideline. Both of these parameters are key determinants of the allowed cost of equity derived under the Sharpe-Lintner CAPM – the AER's proposed Foundation Model. This lack of detail has created unnecessary uncertainty in the regulatory process;
- A reasonable timeframe must be allowed for all stakeholders to consider the AER's views on the values for equity beta and the Market Risk Premium so as to ensure all relevant issues are considered and not to impinge upon procedural fairness requirements of the regulatory process; and
- incentives must be adequate to ensure efficient performance of the gas network service providers (GNSP's), including capital investment and financing activities.

#### 3.2.2. Need to regulate based on objective analysis

- A number of claims and statements were made by consumer representatives at the Stakeholder Consultation (1 October 2013) network service providers debt financing practices and risk profiles. These were largely unsubstantiated by fact and/or evidence. It is important that the AER consider these claims with the same rigour and transparency that it assesses the ENA and other network service providers submissions. This unbiased assessment and decision making process is essential to provide confidence to investors about the objectivity of decision making in the Australian regulatory regime.

## 4. Response to Specific Questions and Issues

### 4.1. Section 3: Benchmark Efficient Entity and Compensation for Risk

The AER's proposed definition of the benchmark efficient entity does not differentiate between gas and electricity distribution/transmission businesses. Envestra explained in its response to the Consultation Paper that the gas sector has a different risk profile to the electricity sector. This reflects the fact that gas is a "fuel of choice" whereas electricity is an essential fuel (as demonstrated by its 100% penetration rate). Despite this, the AER noted in its Draft Guidelines that it considers:

*"...that there is limited risk associated with competition across and between gas and electricity service providers and the risks facing gas and electricity service providers are likely to be similar."*

Envestra does not accept that the risks facing a fuel of choice (i.e. natural gas) are similar to an essential fuel. The availability of substitutes for all natural gas applications has a material impact on the level of competition and the bargaining position of Envestra, users and potential users. Unlike electricity, gas is a discretionary fuel. It is therefore feasible to substitute away from gas but not from electricity. This point was recognised in the MCE Expert Panel's report on energy access pricing:

*"Gas and electricity markets also display different characteristics in terms of the price elasticity of demand and the ability of consumers to seek substitutes. Energy services, and in particular electricity services, are generally considered to have relatively inelastic demand. This inelasticity reflects the essential nature of electricity to commercial and industrial activity and to modern domestic life. **This is less so for gas which is considered to be a 'fuel of choice'; meaning that it is subject to more competition from substitutes.**"*

*While the cost of network services is only part of the final energy price seen by energy consumers, the energy price responsiveness of users can impose some constraints on the exercise of market power in some circumstances.*

*For gas, it could be said that there is a stronger substitution effect, particularly for locations that do not require space heating to any great extent. Electricity, in general, provides a better substitute for gas than gas does for electricity. Consumers are better able to exercise a choice on the source of their energy supply where there are competing sources of supply to a common area."<sup>1</sup> [emphasis added]*

The above extract from the MCE Expert Panel notes that gas has different risk characteristics to electricity, including that gas is more subject to competition than electricity. These are commonly accepted facts and need to be recognised by the AER in its approach to setting the allowed rate of return.

The AER went on to note in its Consultation Paper that it considers:

*"...material competition between gas and electricity is likely to arise where, from the end user's perspective, there is a:*

- *significant change in the relative price of gas and electricity which is viewed to be stable over the longer term*
- *change in the relative efficiency of end user industrial technology and household and commercial heating, lighting and appliance technology."*

<sup>1</sup> MCE Expert Panel on Energy Access Pricing: Report to the Ministerial Council on Energy (April 2006) pp 49-50.

The relative cost of gas and electricity is not viewed to be stable in either the short or medium term across the east coast of Australia. There has been significant recent public commentary on the expected impact on the wholesale cost of gas as a result of the development of an LNG export industry in Australia. To this end, IPART as part of its recent retail gas price review engaged ACIL Tasman to forecast wholesale gas costs over the three years to 2015/16.<sup>2</sup> ACIL forecast that wholesale gas prices will increase by around 50% in 2014/15 and effectively remain at that level for 2015/16<sup>3</sup>. An increase of 50% to wholesale gas cost translates to an increase of approximately 15%<sup>4</sup> to the total gas invoice of residential and small commercial users. The resultant increases for larger commercial and industrial users will be greater as the wholesale gas costs form a much larger part of their total gas invoice.

Using NSW as an example, natural gas and electricity costs in NSW are comparable. The abovementioned expected increase in wholesale gas costs is therefore of significant concern given the worsening of the competitive position of gas relative to electricity overtime. This price differential is of particular concern for gas as a fuel of choice and its competitiveness in the market.

In terms of the second point, Envestra notes there have been considerable changes in the end user technology that has further disadvantaged gas relative to electricity. The most obvious example relates to the increasing penetration of reverse cycle air-conditioning (RCA). Again, using NSW as an example, ABS data shows that the proportion of homes with a RCA increased from 44% in 2002 to 64% in 2011, an increase of around 50%. The increase in RCA penetration reflects reductions in their capital costs and that they heat and cool (unlike their gas equivalent).

The different risk profile of gas and electricity businesses is evident through the different credit ratings assigned by Standard & Poor's to gas businesses relative to electricity businesses. Table 1 below shows that the electricity businesses are on average rated BBB+ while gas businesses are rated BBB to BBB-. This difference in credit rating supports the commonly accepted fact that the risk profiles between gas and electricity businesses are different, with gas being riskier than electricity.

**Table 1**

<b>Australian Regulated Energy Businesses</b>	<b>S&amp;P Rating</b>
<u><i>Gas Network Service Providers</i></u>	
Envestra	BBB, Stable
APT Pipelines (APA)	BBB, Stable
Energy Partnership (Gas) (Multinet)	BBB-, Negative
ATCO Gas Australia	BBB, Positive
SPI Assets	BBB, Stable
DBNGP Trust	BBB-, Stable
<u><i>Electricity Network Service Providers</i></u>	
SA Power Networks	A-, Stable
Citipower	A-, Stable <sup>(1)</sup>
Powercor	A-, Stable <sup>(1)</sup>
ElectraNet	BBB, Stable
United Energy Distribution	BBB, Stable

Note: (1): Without the benefit of majority CKI ownership the stand-alone rating for these entities is one notch lower at BBB+.

<sup>2</sup> ACIL Tasman *DRAFT Cost of gas for the 2013 to 2016 regulatory period* April 2013

<sup>3</sup> Ibid. pages 36 and 37 tables 9, 10 and 11

<sup>4</sup> IPART *Review of regulated retail prices and charges for gas, 2013 to 2016, Gas - Draft Report* April 2013 page 3 – assumes wholesale gas costs make up 30% of a residential and small commercial users total gas invoice

Envestra submits that the different risk profiles between gas and electricity businesses needs to be taken into account by the AER in setting the rate of return. The empirical evidence regarding credit ratings suggests that the assumed credit rating of gas businesses should lie between BBB to BBB-. The empirical evidence on credit ratings also demonstrates that any perceived favourable aspects of the regulatory regime are not sufficient to offset the fundamentally different risk profiles of gas and electricity businesses.

#### 4.1.1 Benchmark Credit Rating

The AER's historical analysis of NSP credit ratings is fundamentally deficient and cannot provide the best estimate of the benchmark NSP credit rating. Credit ratings are forward looking by definition, making analysis of historical medians between 2002 and 2012 irrelevant. The main reason for this is that until 2009 the AER used a value of 1 for equity beta, which with all else constant, provides higher equity returns and a larger cash flow buffer from which to service interest payment obligations – a stronger Financial Risk profile<sup>5</sup>. Short of modelling the credit metrics from each regulatory decision to ensure consistency with published ratings thresholds (Envestra's preferred approach), the current credit ratings of each of the NSP's provide the best indicator of future credit ratings as they embody the ratings agencies expectations of future credit worthiness. This is exactly the same rationale as used by the AER in setting the forward looking risk free rate in setting the rate of return (i.e. the spot yield on the 10-year CGS is the best estimate of the future 10-year CGS yield). Therefore, the benchmark credit rating should be BBB, as shown in Table 7.2 of the Draft Guideline.

#### 4.2. Section 4: Overall Rate of Return

Envestra supports the AER's continued application of the post-tax nominal WACC, and is sympathetic to the proposed annual updating of the cost of debt if the benchmark term to maturity of debt used in the trailing average is 10 years, albeit we are extremely doubtful that the benefits associated with the proposed changes will, in practice, out weigh the administrative costs associated with calculating annual revisions to tariffs, as well as potential litigation arising from disputed calculations. Over the medium to long term, there will be no benefit to consumers or NSP's. The ENA submission on the cost of debt provides evidence from Australian energy network businesses supporting the 10 year term.

#### 4.3. Section 5: Return on Equity

The absence from the Draft Guideline of the AER's views on the probable range of values for equity beta and Market Risk Premium makes it impossible for Envestra to provide constructive feed back on whether the AER's proposed 6-step approach will result in a return on equity consistent with the Rules. Leaving it until the Final Guideline to provide the AER's view on the values for equity beta does not allow for a full and transparent review of the AER's approach, creates uncertainty and is inconsistent with best practice regulation.

An analysis of the equity beta's reported by Commonwealth Securities ('CommSec) for the ASX listed energy NSP's is presented in Table 2 below. CommSec is widely used by equity investors and the research it provides therefore influences investment decisions and portfolio construction.

The equity beta values range from 0.59 to 1.15. The simple average of the CommSec reported equity beta's is 0.81 and the market capitalisation weighted average is 0.79.

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<sup>5</sup> Kanagara Ratings Advisory Services, Credit Ratings for Regulated Energy Network Service Providers, June 2013



CommSec report the sector equity beta as 0.76. This market evidence demonstrates that the current equity beta used by the AER is commensurate with the systematic risk imputed into the ASX listed energy NSP’s assets by investors. This evidence supports the AER’s continued use of 0.8 as the best estimate of the value for equity beta.

Interestingly, APA Group has the lowest reported equity beta at 0.59, and it has the lowest proportion of assets/revenues regulated by the AER. This indicates that the absence of economic regulation results in a level lower systematic risk relative to its regulated peers. Attachment 1 provides the CommSec equity beta information.

**Table 2**

<b>Company</b>	<b>Commonwealth Securities Equity Beta</b>	<b>Market Capitalisation (\$M)</b>
DUET Group	1.15	\$2,648
SP Ausnet	0.87	\$4,085
Envestra	0.78	\$1,968
Spark Infrastructure	0.66	\$2,209
APA Group	0.59	\$4,931
<b>Simple Average</b>	<b>0.81</b>	
<b>Weighted Average</b>	<b>0.79</b>	

Perhaps even more interestingly, we note that Envestra itself is the closest match to the “Regulated Benchmark BBB+” entity and is recorded by CommSec as having an equity beta of 0.78 almost identical to the equity beta currently used by the AER. It is also noteworthy that the Axioma database (which we use for our own internal purposes in calculating cost of capital) currently records Envestra’s equity beta as 0.9 (asset beta of 0.44) and this measure of beta has been relatively stable for some time. Envestra supports the detailed submission by the ENA to the AER Draft Guideline.

#### **4.4. Section 6: Return on Debt**

Envestra understands and is somewhat sympathetic to the proposal to use a trailing average portfolio, updated annually, to estimate the benchmark regulatory return on debt, subject to the reservations outlined above. However, the AER’s analysis and reasoning for determining the seven-year benchmark term of debt is flawed and not representative of actual efficient financing practices of Australian energy network service providers. The ENA submission to the AER Draft Guideline provides evidence from regulated Australian energy network businesses supporting the 10-year term to maturity benchmark. Given this, the proposed transition arrangements will need to be amended to reflect the 10-year term of issuance, as well as the benchmark credit rating of BBB/BBB- for gas network service providers (refer section 4.1).

Therefore, a 10-year trailing average portfolio, updated annually, is the appropriate methodology to estimate the benchmark regulatory return on debt, subject to the reservations expressed in section 4.2. The extrapolated Bloomberg BBB Fair Value Curve is a suitable benchmark from which to estimate the 10-year Debt Risk Premium, although we note the underlying data used is secondary bond market yields and these are likely to under-estimate primary market issuance yields, due to the new issue premium. A number of extrapolation methods have been proposed in the ENA submission to the Draft Guideline and Envestra supports the use of these extrapolation methodologies.

#### 4.4.1 Liquidity

The AER Draft Guideline is silent on the issue of the costs associated with holding liquid assets to comply with the Standard & Poor's liquidity criteria. Standard & Poor's have a policy requirement that an investment grade entity must maintain an "adequate" level of "liquidity", as defined by in the publication "*Standard & Poor's, Methodology And Assumptions: Liquidity Descriptors For Global Corporate Issues*" September 28, 2011:

*Adequate liquidity is rating-neutral. To avoid the risk of default, a company's liquidity must be sufficiently robust to absorb a moderate level of stress. Accordingly, for a company to receive a rating of 'BBB-' or higher, its liquidity must be scored adequate or stronger.*

The benchmark financing structure and the previous regulatory rate of return allowances have not provided an "adequate" level of "liquidity" for Standard & Poor's credit rating purposes<sup>6</sup>. To achieve the "adequate" level of "liquidity" the benchmark NSP needs to be able to access committed and available cash. The amount of required "liquidity" varies with the cash flows of the business. The lowest sustainable cost source of liquidity for the benchmark NSP is undrawn available committed bank debt<sup>7</sup>. The costs of maintaining these facilities are significant and would be incurred by a prudent service provider acting efficiently, in accordance with accepted good industry practice, to achieve the lowest sustainable cost of delivering pipeline services. For example, at 30 June 2013 Envestra Limited had \$400 million of undrawn available committed bank debt to meet its liquidity requirements and maintain an investment grade credit rating, at a cost of \$3.5 - \$4 million per annum.

If the benchmark NSP did not have an investment grade credit rating (i.e. a rating below BBB- is considered non-investment grade) access to capital markets would be restricted and the cost of debt would be higher, flowing through to higher regulatory WACCs and Reference Tariffs. Maintaining an investment grade credit rating is therefore consistent with the NEO/NGO and the Rules. The benchmark costs of maintaining an "adequate" level of "liquidity" must therefore be incorporated into operating cost allowances.

The AER did not agree with Envestra's proposal for liquidity costs in its Victorian Gas Network Draft Decision (December 2012). The AER considered that liquidity costs are provided for in the AER's implicit working capital allowance — which the AER provides through the cashflow timing assumptions in the PTRM<sup>8</sup>. Envestra considers that the AER has incorrectly interpreted the Standard & Poor's liquidity criteria and policy<sup>9</sup> and its reasoning for disallowing the recovery of benchmark liquidity costs is inconsistent with the requirements of the NGL and NGR, particularly in regards to the *allowed rate of return objective*:

- *Rule 87(3) of the NGR* – which provides for the rate of return for a service provider 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 in respect of the provision of reference services.

The following sections describe why the AER has mischaracterised the recovery of liquidity costs as working capital and notwithstanding that error the suggested implicit working capital allowance does not adequately provide for the costs liquidity to such that the benchmark gas distributor achieves an "adequate" level of "liquidity" for Standard & Poor's credit rating purposes.

<sup>6</sup> As demonstrated in the "Liquidity" worksheet included with Envestra's Victorian Network Draft Decision PTRM (Attachment 2).

<sup>7</sup> Envestra estimates the benchmark cost of access to liquidity is between 80-150 bppa. Envestra has used 100 bppa as the benchmark Commitment Fee. Other forms of suitable liquidity are significantly more expensive (e.g. equity, drawn debt).

<sup>8</sup> AER, Draft Decision Envestra Victorian Network (December 2012) – Part 2, page 264

<sup>9</sup> Standard & Poor's, *Methodology And Assumptions: Liquidity Descriptors For Global Corporate Issues* September 28, 2011

## Liquidity & Working Capital

The AER mischaracterised Envestra's liquidity cost proposal as working capital from an accounting perspective<sup>10</sup>, which is commonly defined as current assets divided by current liabilities.

*Working capital is one measure of a service provider's liquidity.<sup>11</sup> It is calculated as current assets minus current liabilities. 'Current' broadly refers to assets/liabilities that will be realised/settled within 12 months<sup>12</sup>*

In its March 2012 Victorian Network Access Arrangement submission Envestra's described the Standard & Poor's liquidity assessment framework for credit rating purposes<sup>13</sup> in detail. It is much broader than the accounting definition of working capital, as it takes into account internally generated cash inflows and outflows, capital expenditure and undrawn available committed bank lines, banking relationships and debt covenants (amongst other items). Basically Standard & Poor's undertake a "sources and uses" analysis of liquidity to determine where an individual company lies on its liquidity spectrum. Sources and uses of liquidity as defined by Standard & Poor's are listed below:

### Sources:

- Cash and liquid investments;
- Forecasted funds from operations (FFO), if positive;
- Forecasted working capital inflows, if positive;
- Proceeds of asset sales (when confidently predictable);
- The undrawn, available portion of committed bank lines maturing beyond the next 12 months; and
- Expected ongoing cash injections from a government or corporate group members, as appropriate.

### Uses:

- Forecasted funds from operations, if negative;
- Expected capital spending;
- Forecasted working capital outflows, if negative;
- All debt maturities (either recourse to the company or which it is expected to support);
- Any required cash-based, postretirement employee benefit top-up needs;

<sup>10</sup> AER, Draft Decision Envestra Victorian Network (December 2012) Part 2, page 266

<sup>11</sup> Marshall, I. David, H. Accounting: what the numbers mean, 2nd edn, p. 304. R, Shield, Financial accounting and company accounts, 2004, p. 7.

<sup>12</sup> AASB 101. An entity shall classify an asset as current when:

- (a) t expects to realise the asset, or intends to sell or consume it, in its normal operating cycle;
- (b) t holds the asset primarily for the purpose of trading;
- (c) t expects to realise the asset within twelve months after the reporting period; or
- (d) he asset is cash or a cash equivalent (as defined in AASB 107) unless the asset is restricted from being exchanged or used to settle a liability for at least twelve months after the reporting period.

An entity shall classify all other assets as non-current.

<sup>13</sup> Envestra Limited, *Victorian Access Arrangement Information*, March 2012, p163-164

- Credit puts that cause debt acceleration or new collateral posting requirements in the event of a ratings downgrade of up to three notches; and
- Contracted acquisitions and expected shareholder distributions under a stress scenario, including expected share repurchases.

The Standard & Poor's liquidity assessment framework is much more comprehensive than the simple working capital financial metric the AER has described. A business with positive working capital will only be awarded an investment grade credit rating if Standard & Poor's assess it to have "adequate" level of "liquidity". We note only for purposes of completeness, and consistency of content, that Moody's requires similar liquidity standards as those outlined above.

### Implicit allowance for working capital in the PTRM

The AER used working capital analysis undertaken by the Allens Consulting Group ('ACG') in 2002 to show that, as a rule of thumb, the PTRM provides revenue of 1.8% greater than the Annual Revenue Requirement. This is an inadequate analysis as ACG<sup>14</sup> relies on a number of abstract, unrealistic and theoretical assumptions to support the claim that the cash flow timing assumptions in the PTRM provide an implicit working capital allowance.

Some of the major assumptions (i) are not consistent with the AER's current revenue setting framework and/or (ii) spuriously ascribe a level of precision to the analytical framework that is not supported by real world experience. For example, the ACG working capital analysis was undertaken in real pre-tax terms, whereas the AER's revenue setting framework is nominal post-tax. This difference is significant as it automatically gives rise to a cash flow deficit, due to the non-zero value for gamma. This creates a difference in the benchmark tax payable and the benchmark taxation allowance included in the Annual Revenue Requirement<sup>15</sup>.

Another abstraction from practical realities is the assumption of constant periodic gas consumption and revenue inflows. Gas consumption varies with weather conditions (amongst other factors). Gas consumption is not constant as it is influenced by the weather, with peak consumption in the cooler winter months. The significant differences between the higher gas consumption forecasts approved and the lower actual consumption over the 2008-2012 regulatory period were significant. The negative cash flow impact of these differences swamped any theoretical working capital benefit as indicated by the AER.

As a result, there may not be a positive amount of implicit working capital available to the business. However, if we do use the extreme assumption that the PTRM provides 1.8% of revenue from implicit working capital, it is not sufficient to compensate the benchmark gas distributor for the cost to maintain and "adequate" level of liquidity under the Standard & Poor's assessment framework, as we show in the next section.

### The Benchmark Cost of Liquidity

The two main quantitative analyses used by Standard & Poor's to assess liquidity (i) "sources" divided by "uses" must be greater than 1.2 times and (ii) "sources" less "uses" must be positive after allowing for a 15% decline in EBITDA.

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<sup>14</sup> ACG, Working capital—Relevance for the Assessment of Reference Tariffs, March 2002

<sup>15</sup> For clarity benchmark tax payable is 1.33 times (i.e.  $1/(1-\gamma)$ ) where  $\gamma$  is 0.25) higher than the benchmark tax allowance included in the Annual Revenue Requirement.

The Liquidity analysis below (Table 3) is an extract from the “Liquidity Costs” worksheet included in Envestra Victoria Draft Decision PTRM (Attachment 2). It uses details the calculations required to achieve “Sources” divided by “Uses” of greater than 1.2 and a positive value for “Sources” less “Uses”. Undrawn available committed bank debt is the variable used to achieve the minimum “adequate” level of liquidity for the benchmark NSP (number [1]). Notwithstanding the dubious nature of the AER’s claim of implicit working capital, the Liquidity Analysis allows for the 1.8% of revenue from the implicit working capital as one of the “Sources” of funds (number [2]). The alleged presence of implicit working capital does not preclude the need for NSP’s to maintain significant amounts of undrawn available committed bank debt for liquidity purposes.

Total Liquidity Sources (A), as defined by Standard & Poor’s, are shown in line [3], Total Liquidity Uses (B) are shown in line [4]. For liquidity to be rated as “adequate” Sources (A) divided by Uses (B) must be greater than 1.2 times, and this is shown in line [5], with the value of undrawn committed bank used as the variable (number [1]) to achieve the minimum value of 1.2 times. The annual cost of maintaining undrawn committed bank is derived in line [7], at \$7.85 million over the Access Arrangement period.

This Liquidity Analysis demonstrates that the benchmark regulated NSP prudently incurs costs associated with maintaining liquidity for credit ratings purposes, in the form of undrawn committed bank. The AER does not currently allow for the recovery of these costs, effectively assuming they do not exist. Using the example of Envestra’s Victorian Network Draft Decision, we estimate this cost at \$1.57 million per annum on average (or 21 basis points per annum [9]) over the 2013 to 2017 Access Arrangement period. This is the benchmark cost incurred to maintain an “adequate” level of liquidity in order to be awarded an investment grade credit rating.

Envestra proposes that in determining the benchmark Cost of Debt ( $K_d$ ), which is derived as the sum of the Risk Free Rate ( $R_f$ ) and Debt Risk Premium (DRP), the AER include the recovery of 21 bp of Liquidity Costs (LC). The benchmark Cost of Debt would then become the sum  $R_f$ , DRP and LC (i.e.  $K_d = R_f + DRP + LC$ ).

**Table 3**

	<b>Liquidity Cost Analysis (\$M NOMINAL)</b>	<b>2013</b>	<b>2014</b>	<b>2015</b>	<b>2016</b>	<b>2017</b>
	<b>Sources (A)</b>					
	Cash and liquid investments	0.0	0.0	0.0	0.0	0.0
[1]	<b>Undrawn committed bank facilities</b>	<b>155.0</b>	<b>165.0</b>	<b>155.0</b>	<b>165.0</b>	<b>145.0</b>
[2]	Net working capital inflows (1.8% of revenue)	3.0	3.1	3.1	3.2	3.2
	Funds from operations	58.2	53.7	49.9	47.2	45.6
	Proceeds of asset sales	0.0	0.0	0.0	0.0	0.0
[3]	<b>Total liquidity sources (A)</b>	<b>216.2</b>	<b>221.7</b>	<b>208.0</b>	<b>215.4</b>	<b>193.9</b>
	<b>Debt headroom</b>					
	Drawn debt	686.2	727.6	762.9	792.5	816.5
	Undrawn Committed Bank Debt	155.0	165.0	155.0	165.0	145.0
	<b>Total available debt facilities</b>	<b>841.2</b>	<b>892.6</b>	<b>917.9</b>	<b>957.5</b>	<b>961.5</b>
	<b>Uses (B)</b>					
	Funds from operations	0.0	0.0	0.0	0.0	0.0
	Expected capital expenditure	79.9	84.5	65.6	72.5	51.7
	Net working capital outflows	0.0	0.0	0.0	0.0	0.0
	Debt maturing within 12 months (1/10th of average debt)	68.6	72.8	76.3	79.3	81.7
	Shareholder Dividends	29.2	28.1	27.4	26.9	26.8
	Pension top-up needs	0.0	0.0	0.0	0.0	0.0
[4]	<b>Total liquidity uses (B)</b>	<b>177.8</b>	<b>185.4</b>	<b>169.2</b>	<b>178.6</b>	<b>160.2</b>
	<b>Liquidity ratios</b>					
[5]	<b>Total sources/Total uses (A/B) (times)</b>	<b>1.2</b>	<b>1.2</b>	<b>1.2</b>	<b>1.2</b>	<b>1.2</b>
[6]	<b>Total sources-Total uses (A - B) (\$M)</b>	<b>38.4</b>	<b>36.4</b>	<b>38.7</b>	<b>36.8</b>	<b>33.7</b>
	Cost of undrawn committed bank facilities	1.00%	1.00%	1.00%	1.00%	1.00%
[7]	<b>Cost of Liquidity \$M nominal</b>	<b>\$1.55</b>	<b>\$1.65</b>	<b>\$1.55</b>	<b>\$1.65</b>	<b>\$1.45</b>
[8]	<b>Increment required to the Cost of Debt</b>	<b>0.23%</b>	<b>0.23%</b>	<b>0.20%</b>	<b>0.21%</b>	<b>0.18%</b>
	<b>Total Liquidity Cost over Access Arrangement Period</b>	<b>\$7.85</b>	<b>\$M nominal</b>			
[9]	<b>Average increment to cost of debt for cost recovery</b>	<b>21</b>	<b>basis points</b>			

#### 4.5. Section 7: Imputation Credits

We believe the AER’s proposed change for the value of imputation credits from 0.25 to 0.5 is totally without merit given that no relevant new information has been presented since the issue was considered by the Australian Competition Tribunal in 2010. This is a complex issue and it is surprising that the AER would propose such a change given the issue was adjudicated upon so recently. Envestra supports the detailed submission by the ENA to the AER Draft Guideline on this issue, but notes that Independent Valuation Experts routinely consider the value of imputation credits and the consensus value assigned is zero, making the 0.25 value determined by the Australian Competition Tribunal generous.