

15 February 2013

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



via email: rateofreturn@aer.gov.au

Dear Mr Anderson

Submission to Rate of Return Guidelines Issues Paper

Thank you for providing Envestra with the opportunity to make a submission to the way the rate of return is to be determined under the revised National Gas Rules (NGR) and the new allowed rate of return objective, which 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 network service provider.

Envestra is a publicly listed company that owns five regulated natural gas distribution networks across Australia. Envestra considers that it is well placed to comment on the issues raised in the **Rate of Return Guidelines Issues Paper** given the regulated nature of its assets and the resultant experience it has in operating under the Australian regulatory regime over the past 15 years (and consequently participating in over 10 regulatory review processes).

The revised NGR require the AER to consider a broad range of information in determining the rate of return. Envestra considers that this information should include the decisions made in Independent Expert Reports which provide an unbiased and robust view as to the required overall rate of return. Reference to this material will enable the AER to fulfil its obligations under the Rule 87 of the revised NGR.

Envestra encourages the AER to continue to develop an approach to setting the rate of return that provides consistent outcomes reflecting market conditions. A regulatory rate of return set without reference to market requirements will distort investment and compromise the long-term interest of consumers.

These matters are discussed further in the detailed submission attached to this letter. Please feel free to contact either myself on 08 8418 1124 or Craig de Laine (08 8418 1129) if you would like to discuss this submission further.

Yours Sincerely

A handwritten signature in blue ink, appearing to read 'Ian Little'.

Ian Little
Managing Director



Executive Summary

The AEMC has recently made changes to the way the rate of return is to be determined under the revised National Gas Rules (NGR). The NGR require the AER to release a non-binding guideline explaining how the AER intends to estimate the rate of return, including the information that will be taken into account at the time of each determination. This submission responds to the Issues Paper recently released by the AER on this matter. The AER Issues Paper is an important step in the development of the Guideline particularly given its focus on key principles and concepts to be applied by the AER in setting the rate of return.

Envestra is generally supportive of the broad principles developed by the AER for assessing the rate of return. These principles are generally not inconsistent with the detailed direction for setting the rate of return contained in the NGR. However, Envestra does have a concern with the principles that requires the rate of return to be “supportive of broader regulatory aims” and for decisions across different regulators to be applied consistently. Envestra therefore submits that these principles be removed.

Envestra considers that an additional principle should be added requiring that the methodologies used should generate results that are consistent with the rate of return outcomes generated by market experts, particularly those set out in Independent Expert Reports. Envestra considers that the rate of return determined by Independent Experts provides an important market based independent reference point as to whether the allowed rate of return objective has been met.

Responses to the Issues Paper Questions

1. Principles Based Approach

Question 1

Do stakeholders consider that following these principles would promote the allowed rate of return objective?
Should any of the principles be considered as more prominent or important than others?

Response to Question 1

Envestra supports the AERs use of an appropriate set of principles (or considerations) when making rate of return determinations. They need to comply with the National Gas Law ('NGL'), National Gas Rules ('NGR'), fulfil the National Gas Objective ('NGO') and be consistently applied by the AER.

Envestra is concerned that some of the principles proposed by the AER are either not necessary, or subjugate, the NGR and NGL. For example, the principle that methodologies are consistently applied across Regulators is (a) not a requirement of the NGL/NGR and (b) may in itself be unachievable due to different Regulators taking different approaches on various aspects of the cost of capital.

None of the AERs proposed principles should impede or prevent the NGR or NGO from being fulfilled.

Question 2

Are there other principles or criteria which should be considered?

Response to Question 2

Independent Expert Valuer's ('IEVs') have a task that is analogous to that of the AER with respect to the rate of return. IEVs are required by the Corporations Law to determine the value of an asset that a willing, but not anxious, buyer and seller would be prepared to pay. This distils down to an assessment of the appropriate rate of return taking into consideration of the risks associated with the asset, which is the essence of the allowed rate of return objective:

The allowed rate of return objective is that the rate of return for a Distribution Network Service Provider 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 Distribution Network Service Provider in respect of the provision of standard control services (the allowed rate of return objective).¹

An allowed rate of return that is not reflective of market requirements will result in a misallocation of capital to Distribution Network Service Providers, which will affect the safety, timeliness and reliability of regulated energy transportation services. This would not serve the long-term interests of consumers.

Therefore, Envestra suggests that the AER adopt the principle that methodologies used should generate results that are consistent with the rate of return outcomes determined by market experts, particularly those set out in Independent Expert Reports. This is consistent with the requirements of the NGR.

Question 3

Do stakeholders have a broad preference for predictability or flexibility, and do these preferences differ at each level (the overall rate of return, the return on equity and debt, and at the parameter level) of the rate of return?

Response to Question 3

The AERs current approach to setting the cost of equity with the Sharpe-Lintner CAPM, the short-term average risk free rate (proxied by the yield on 10 year Commonwealth Government Securities), an equity beta of 0.8 and an long-term average Market Risk Premium of 6% is highly predictable but produces highly variable outcomes that, in recent times, does not reflect the rate of return required by equity capital providers.

Envestra has a preference for the benchmark return on equity and return on debt to reflect investor requirements supported by market based evidence contained in Independent Expert Reports. This approach is consistent with the NGL/NGR as Independent Expert Reports invariably use a range of methods to assess the rate of return. It also provides a high degree of predictability as the Independent Expert Reports will provide an objective rate of return estimate consistent with capital market requirements.

Question 4

To what extent should the guideline set out a pre-determined approach that can then be applied at each determination?

¹ NER, cl. 6A.6.2(c); NGR, r. 87(3).

Response to Question 4

Envestra considers that the Guideline should provide an objective and transparent framework that enables stakeholders to understand how the allowed rate of return will be determined and, absent material changes in market circumstances, calculate the standard rate of return. The actual allowed rate of return used in a regulatory determination could ultimately be different from that derived using the standard approach contained in the Guideline if market conditions were to change such that the standard assumptions were no longer appropriate.

2. Key Concepts and Terms

Question 5

Aside from a balance between debt and equity financing, are there other characteristics of the way in which an efficiently financed entity would approach its financing task that should be considered in estimating the allowed rate of return?

Response to Question 5

Yes, the concepts of a benchmark efficient notional entity needs to be defined and used by the AER in determining the allowed rate of return. The interrelationships between the cost of equity, the cost of debt, credit rating and liquidity need to be explicitly considered in the AER decision making process. In addition, the benchmark cost of debt allowance needs to be set with reference to efficient financing practices taking into account an appropriate credit rating benchmark, allowances for debt raising costs and the costs of managing liquidity.

Question 6

Is it still appropriate to separate a conceptual benchmark from its practical implementation?

Response to Question 6

Yes, it is appropriate to set the allowed rate of return using the characteristics of the conceptual benchmark efficient entity.

Question 7

Does the current definition reflect an appropriate level of detail for the conceptual definition? Are there other factors which should be considered?

Question 8

In relation to the current definition of the conceptual benchmark, is more or less detail preferable?

Response to Questions 7 & 8

Envestra's preferred definition is:

"A 'pure-play' regulated electricity or gas network business operating within Australia without parental ownership providing the same scale and scope of services to the same customer base in the same regulatory period."

Envestra considers that it is unreasonable to assume that a service provider will have parent ownership or support. Such a requirement would be inconsistent with the revenue and pricing principles set out in section 24 of the National Gas Law, particularly:

- *Section 24(2)* – which requires a service provider to be provided with a reasonable opportunity to recover at least its efficient costs; and
- *Section 24(5)* – which requires a reference tariff to allow for a return commensurate with the regulatory and commercial risks; and
- *Section 24(6)* – which requires regard to be had to the economic cost and risk of under investment.

These factors would be significant for Envestra given it is a private company that lacks parent ownership and/or support.

Question 9

Are the proposed factors reasonable?

Response to Question 9

At a high level the proposed factors appear reasonable. However, Envestra has concerns about the decision making process surrounding their implementation, and the choice of data that the AER may consider acceptable. We would expect to see further details about implementation and data sources in the Consultation Paper, after which we can further respond.

Question 10

Are there other factors which should be considered?

Response to Question 10

The guiding factor of using observed market practices to determine the allowed rate of return will ensure the cost of equity and cost of debt reflect market conditions and this will promote predictability in decision making. Where possible the practical implementation should reflect the conceptual definition and use of benchmarks. This will create incentives for the regulated entity to achieve efficient outcomes.

An important factor is "interrelatedness" of parameters in the AERs regulatory decision. For example, if the cost of debt is set using a benchmark credit rating of say BBB, yet the financial metrics from that regulatory decision only justify a 'BB' rating then this would indicate that there is an inconsistency in the regulatory decision that needs to be corrected prior to finalising. If inconsistencies were to remain, consumers may benefit from lower prices in the short-term, but in the medium to long-term access to capital will become constrained and the provision of services will fall below desired levels to the long-term detriment of consumers.

In addition, the AER should limit the analytical task to depart from the conceptual benchmark only to the extent necessary to ensure statistically robust estimates. Envestra considers these additional factors will strengthen the regulatory decision making process.

Question 11

Are there characteristics that differentiate the level of risk in the gas and electricity sectors, or between distribution and transmission networks?

Question 12

Are there other characteristics that should be taken into account when assessing the level of risk?

Question 13

To the extent that different risk levels exist, can these differences be estimated in a manner consistent with the regulatory principles outlined in section 2?

Responses to Questions 11, 12 and 13

There is a high degree of commonality between most gas and electricity network businesses and between distribution and transmission. However, there are circumstances (e.g. a gas transmission business with a relatively small RAB supplying services to a small number of customers of high credit risk) that may warrant a departure from the characteristics that apply generally. Issues such as these need to be further considered.

3. Overall Rate of Return

Question 14

To date our practice has been to estimate the allowed rate of return based on the standard WACC formula. Should we continue with this, or if not, what alternative approaches should be explored?

Answer to Question 14

See response to question 2.

Question 15

How can overall rate of return considerations be used under the new rule framework? This may include consideration of the relevance of the methodologies identified above (or others not yet identified), and how such information could be used.

Answer to Question 15

These considerations should apply at the overall decision making level rather than to individual methodologies in isolation. None of them should be applied as 'absolute' criteria capable of being met or being failed. Nor should they apply as a 'score sheet' in which different approaches satisfy a higher or lower discrete number of considerations. The overall WACC considerations need to be carefully constructed to ensure methodologies produce commercially feasible outcomes.

Envestra has a preference for the benchmark return on equity and return on debt to reflect investor requirements supported by market based evidence contained in Independent Expert Reports. This will provide a high degree of predictability as the Independent Expert Reports will provide an objective rate of return estimate consistent with capital market conditions.

4. Return on Equity

Question 16

Are the assessment criteria presented in section 3.1 an appropriate basis for evaluating the cost of equity methodology in order to meet the allowed rate of return objective?

Answer to Question 16

See the answers to Questions 1 & 2.

Question 17

What overall cost of equity methodology best meets the allowed rate of return objective?

Question 18

What individual cost of equity model best meets the allowed rate of return objective?

Question 19

What other evidence (estimation methods, financial models, market data and other estimates) is relevant to the determination of the cost of equity?

Answers to Questions 17, 18 & 19

No single asset pricing model can be used to satisfy the allowed rate of return objective. Some do not perform well in empirical testing whilst some are considered less academically rigorous than others.

Envestra's preference for the benchmark return on equity and return on debt to reflect investor requirements supported by market based evidence contained Independent Expert Reports. This approach is consistent with the NGR/NGL as Independent Expert Reports invariably use a range of methods and data to assess the rate of return. It also provides a high degree of predictability as the Independent Expert Reports will provide an assessment of the rate of return estimate consistent with capital market conditions.

5. Return on Debt

Question 20

What are the advantages and disadvantages of portfolio approaches compared with the current "on the day" approach to the return on debt?

Question 21

How do these approaches align with the principles of an efficient financing benchmark, as set out in section 4.2?

Answer to Question 20 & 21

The 'on the day' approach has been in operation in Australia for over 20 years, it well understood, transparent and it provides a relatively simple way to set a benchmark cost of debt. Some stakeholders have argued that the 'on the day' is approach has a number of weaknesses and practical difficulties. However, there will inevitably be weaknesses with any estimation methodology.

The advantages of a portfolio approach are that it reflects a prudent method of managing the risks associated with a large debt portfolio. Further, it is consistent with practices used by capital intensive businesses that are not subject to economic regulation. This is the key question to be asked by the AER in assessing any change from the 'on the day' approach as the regulatory framework has caused businesses to implement risk management strategies that would not of otherwise been undertaken in the absence of regulation (e.g. using interest rate swaps to fix the base interest rate on the debt such that it aligns with the risk free rate in the regulatory WACC). Ideally, interest rate risk would be managed in the physical debt market rather than synthetically via the use of derivatives due to lower costs and complexity. A move away from the "on the day" approach will require appropriate transition arrangements to ensure DNSPs are not disadvantaged due to the changes in the NGR. The details are most appropriately explored in the Consultation Paper and considered by the Working Group.

Question 22

What are the characteristics of efficient and prudent financing practices that should be taken into account under a benchmark framework?

Answers to Questions 22

As discussed above, the 'on the day' approach has been a key feature of the regulatory regime and it has caused the privately owned regulated business to manage interest rate risk a particular way (i.e. hedge the base interest rate on the debt portfolio for the length of the regulatory period). If the AER moves away from the 'on the day' approach then past risk management practices may not be relevant under the new benchmark framework, whether it is a portfolio approach or something else.

The AER therefore needs to consider the prudent and efficient debt portfolio management practices for relatively highly geared² with businesses operating without the constraints of economic regulation, that are capital intensive have [assets with long lives (i.e. 50-100 years)]. Other necessary considerations for the AER are accessibility to debt financing, maintenance of the benchmark credit rating, efficient liquidity management and managing refinancing risk.

² The benchmark gearing assumption for regulated energy distribution and transmission businesses is 60% debt, whereas Other Corporates listed on the ASX have a gearing level close to 30%.