

Ergon Energy Corporation Limited

Submission on the *Draft Rate of Return
Guidelines and Explanatory Statement*

Australian Energy Regulator

11 October 2013



**Submission on the *Draft Rate of Return
Guideline and Explanatory Statement*
Australian Energy Regulator
11 October 2013**

This submission, which is available for publication, is made by:

Ergon Energy Corporation Limited
PO Box 15107
City East
BRISBANE QLD 4002

Enquiries or further communications should be directed to:

Jenny Doyle
Group Manager Regulatory Affairs
Ergon Energy Corporation Limited
Email: jenny.doyle@ergon.com.au
Ph: (07) 4092 9813
Mobile: 0427 156 897





1. INTRODUCTION

Ergon Energy Corporation Limited (Ergon Energy), in its capacity as a Distribution Network Service Provider (DNSP) in Queensland, welcomes the opportunity to provide comment to the Australian Energy Regulator (AER) on its *Draft Rate of Return Guidelines* (Draft Guidelines) and *Explanatory Statement*.

The Queensland Treasury Corporation (QTC) has prepared a comprehensive response to the AER's Draft Guidelines. Ergon Energy fully supports the comments contained in the QTC's submission. Furthermore, as a member of the Energy Network Association (ENA), the peak national body for Australia's energy networks, Ergon Energy supports the comments contained in the ENA's submission relating to the rate of return (return on equity and return on debt) and the value of imputation credits ('gamma').

In response to the AER's invitation to provide comments on the Draft Guidelines, Ergon Energy has provided high level responses and directs the AER to the QTC and ENA submissions for further detail. Ergon Energy is available to discuss this submission or provide further detail regarding the issues raised, should the AER require.



2. GENERAL COMMENTS

This section provides high level comments on the return on equity, imputation credits (gamma), benchmark credit rating and return on debt.

2.1. Return on Equity

Ergon Energy agrees with the ENA's submission that the AER's proposed approach to estimating the cost of equity is potentially inconsistent with the regulatory rules. Ergon Energy considers the ENA's 'multiple-model' approach preferred by the network sector provides a transparent means of determining the cost of equity and gives each relevant model and piece of evidence due weight based on an assessment of its merits. In comparison, Ergon Energy considers the AER's preferred 'foundation model' approach is unlikely to deliver robust, transparent and predictable outcomes through the cost of equity estimation process due to the issues outlined by the ENA. Ergon Energy concurs with the ENA that the foundation model is underdeveloped and uncertain in operation. On this basis, Ergon Energy considers the ENA's multiple-model approach should be used to determine the allowed return on equity. However, to the extent the AER pursues its proposed foundational model approach Ergon Energy recommends the AER address the issues raised by the ENA. Refer section 3.1.6 of the ENA submission for their summary on the cost of equity framework issues.

2.2. Imputation Credits (i.e. Gamma)

Ergon Energy supports the ENA's submission and conclusion that the current best estimate of gamma is 0.25, unchanged from recent AER and Tribunal decisions over the past three years and based on an estimate of theta of 0.35 derived from the dividend drop off studies. Ergon Energy does not support the AER's 'equity ownership' conceptual framework for establishing gamma proposed in the Draft Guideline and Explanatory Statement, for the reasons outlined in the ENA's submission.

2.3. Benchmark Credit Rating

Consistent with the ENA submission, Ergon Energy considers the most recent observations of credit ratings and not the average credit rating over the last decade should be used to determine the benchmark credit rating to apply to estimate the cost of debt. Based on the 2013 observations provided by the ENA, the evidence suggests that a credit rating of BBB⁻ to BBB is appropriate. Ergon Energy considers the Guidelines should incorporate the benchmark credit rating most likely to exist over the period the Guidelines will be applied. That is, the AER should set a forward-looking credit rating in the Guidelines.

2.4. Return on Debt

2.4.1 *Benchmark Debt Term*

Ergon Energy broadly supports the AER's adoption of a trailing average portfolio approach with annual updating to estimate the benchmark return on debt allowance and agrees this is a major change in the regulatory framework. However, Ergon Energy does not support the AER's proposal to reduce the benchmark term of debt from ten years to seven years and considers the AER should have included its proposed position and supporting evidence in the Consultation Paper to afford stakeholders the opportunity to review and scrutinise the evidence relied on prior to the release of the AER's Draft Determination and Rate of Return Guidelines. Ergon Energy strongly considers the trailing average should be calculated over a ten year period, consistent with the majority of stakeholder submissions to the AER's Consultation Paper which supported the continuation of a ten year benchmark term for estimating the return on debt. A benchmark debt tenor which is less than ten years is unlikely to be commensurate with the cost of debt for the benchmark efficient entity nor meet the allowed rate of return objective. A sufficiently long benchmark debt tenor is required to enable service providers to manage refinancing risk by ensuring only a small percentage of the total borrowing matures each year. A longer debt term will also produce a more stable return on debt allowance relative to a shorter term, which is in



the long term interests of consumers. The evidence provided by the QTC and the ENA on the observed financing practices of regulated and unregulated infrastructure businesses supports a benchmark debt term of at least 10 years.

The AER has relied on an analysis of the 'effective term of debt' to support its proposal to reduce the benchmark debt term to seven years. Advice provided by Martin Lally which claims that it is efficient practice for service providers to swap the base rate component of their debt to a term shorter than ten years, has also been cited to support the proposed reduction. QTC's submission to the Draft Guideline identifies a number of flaws in the AER's analysis, and concludes that it cannot be relied on to justify a reduction in the benchmark debt tenor. Similarly, Lally's advice is shown to be based on an assumption that the lower interest rate (inclusive of all transaction costs) on a shorter-term swap more than offsets the higher interest rate risk compared to base rate implicit in ten year fixed rate debt.

Ergon Energy also disagrees with the AER's conclusion that the term premium between seven and ten-years is 'not material'. The AER calculated the average difference in yield at 21 basis points. Using Ergon Energy's current \$5 billion debt facility with QTC as an example, a 21 basis points difference equates to an annual interest cost of \$10.5 million or \$52.5 million over the five year regulatory control period. Ergon Energy considers these costs are material. QTC further estimates the average term premium implicit in the AER's return on debt decisions since early 2012 to be 64 basis points. A 64 basis point margin equates to an annual interest charge of approximately \$32 million or \$160 million over the five year regulatory control period. For further detailed analysis regarding the term premium, please refer to the QTC's submission.

In summary, Ergon Energy strongly disagrees with the AER's proposition that the benchmark debt term is likely to be less than ten years and considers that the available evidence and theory does not support a reduction in the benchmark debt term from ten to seven years. Ergon Energy also considers that the term premium between seven and ten years is material for the benchmark efficient entity, based on QTC's analysis.

The AER has also referred to the practical difficulty in automating the annual updates in estimating the return on debt as a reason for reducing the benchmark term of debt from ten years to seven years. Ergon Energy supports consideration of the extrapolation methods proposed by the QTC and the ENA in order to mechanistically extrapolate the Bloomberg 7-year BBB fair value curve to a ten year tenor. Ergon Energy further agrees with the ENA that the extrapolation method of the 7 year cost of debt to the 10 year benchmark should be specified in the Guidelines and must include extrapolation of the risk free rate and the debt risk premium (DRP) from 7 years to 10 years. The Guidelines should also specify the specific form of mechanistic extrapolation of the DRP component, such as the QTC proposal (refer Attachment A to QTC's submission), the AER's paired bond analysis or other alternate method.

2.4.2 Weighting

The AER's decision to use an unweighted simple average may lead to investment distortions especially for service providers with large capital expenditure programs. The AER's proposed approach also involves an implicit weighting scheme that cannot be replicated in practice. That is, a business cannot raise new debt today at the same average historical rate that will be used to compensate the new borrowing. This point was made in QTC's submission on the AER's Consultation paper at page 6, as follows:

An unweighted average will compensate all increases in the debt balance 'as if' they were funded at historical rates. As it is not possible for a service provider to issue new debt at historical rates, an unweighted trailing average will naturally produce a difference between the return on debt and interest rate on the new debt for the benchmark efficient entity. This breaches the objectives of productive, allocative and dynamic efficiency and is contrary to the AEMC's view regarding incentives for efficient capex:

*'The impact on the incentives for efficient capex is also an important consideration. **The incentives for efficient capex are stronger when the difference between the return on debt and the debt servicing costs of the service provider is minimised.**' [emphasis added]*



Minimising the difference between the return on debt and the service provider's debt servicing costs requires new borrowings to be compensated at the prevailing cost of debt. This can only be achieved by using a weighted trailing average.

Compensating new investment at historical rates is also inconsistent with the allowed rate of return objective as any meaningful estimate of efficient financing costs must reflect the costs that can actually be achieved in practice.¹

In summary, Ergon Energy supports a weighted average approach for estimating the allowed return on debt in preference to a simple unweighted average in order to minimise investment distortions and to enable new borrowings to be compensated based on the prevailing cost of debt. Refer to the QTC's submission for further detail in this regard.

2.4.3 Transitional Arrangements

Ergon Energy supports the 'QTC method' of transition outlined by the AER in the Draft Guideline, without the modifications to the benchmark tenor proposed by the AER. As stated above, Ergon Energy considers a benchmark debt term of ten years is appropriate.

2.4.4 Averaging period to estimate the allowed return on debt

The Draft Guideline allows a service provider to nominate the averaging period to be used in each regulatory year to update the trailing average. Each averaging period must be in the future and contain at least ten consecutive business days.

The Draft Guideline also outlines the starting dates and the end dates for the first agreed averaging period and subsequent regulatory years in the regulatory control period. For service providers on financial regulatory years, the AER has proposed that the averaging period in subsequent regulatory years can be any period of 10 or more consecutive business days within the most recently concluded 1 January to 31 December calendar year. The AER states at page 103: *'This is to provide service providers with sufficient time to calculate return on debt and be approved by us before they submit their annual pricing proposals for the upcoming regulatory year.'*²

Ergon Energy considers an averaging period which ends six months before the commencement of the relevant regulatory year to be unnecessarily long. In practice, very little primary debt issuance is undertaken in the domestic debt market in November and December. If a service provider nominates an averaging period in October, there will be an eight month lag before the interest rates on these transactions are reflected in the benchmark return on debt. The lag will be even longer for service providers that seek to spread their debt issuance over a longer period of time.

Ergon Energy considers that service providers should have the opportunity to nominate alternate averaging periods and not be constrained by the averaging periods proposed in the draft guideline, particularly in relation to the first agreed averaging period. For those service providers transitioning from the 'on the day' approach to a trailing average approach, a narrow averaging period may expose network service providers to a significant mismatch between the regulatory cost of debt allowance and actual cost of debt. Service providers should have the opportunity to request sufficiently long averaging periods, provided the request is made in advance (in consultation with the AER) and the nominated averaging period is in the future. Ergon Energy considers service providers' nominated averaging periods may need to commence prior to the submission of a service providers' Regulatory Proposal in order to ensure the service provider is not disadvantaged by the transition from the 'on the day approach' to a trailing average approach. On this basis, Ergon Energy would support the starting date for the first agreed averaging period being brought forward.

¹ QTC, *Rate of Return Guidelines Consultation Paper – Submission to the Australian Energy Regulator*, June 2013, p.6.

² AER, *Better Regulation, Explanatory Statement - Draft Rate of Return Guideline*, August 2013, p.103.





The first averaging period needs to be sufficiently long as it has the greatest impact on the trailing average. The AER should not employ the previous approach of using a 10-40 day average. A longer averaging period would smooth out any volatility which would benefit consumers and would lead to a better implementation of the trailing average over the longer term.

In the Draft Guideline, the AER has indicated that the starting date for the first agreed averaging period will commence after submission of a service provider's Regulatory Proposal, and in Ergon Energy's case will end no later than a month before the release of the AER's draft decision (for service providers' subject to a 'preliminary determination with a mandatory re-opener'). The maximum potential number of days for the first agreed averaging period is 150 days. In comparison, the maximum potential number of days for subsequent averaging periods is 365 days. Ergon Energy considers the first averaging period is somewhat short. Ergon Energy believes there should be a longer averaging period for the first agreed averaging period than that currently allowed in the Draft Guideline. This is to enable a better implementation of the trailing average approach as the first agreed averaging period has the greatest impact on the trailing average over the transitional period and will lead to better outcomes for consumers in terms of reduced price volatility. It should also be noted that service providers cannot issue debt twice, and therefore the AER's proposal for overlapping averaging periods for the first and second agreed averaging periods cannot be replicated in practice.

