

Ergon Energy Corporation Limited

Submission on the *Rate of Return
Guidelines Issues Paper*
Australian Energy Regulator
15 February 2013



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

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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 *Rate of Return Guidelines* Issues Paper.

Queensland Treasury Corporation (QTC) has prepared a comprehensive response to the issues raised by the AER. Ergon Energy fully supports the comments contained in their submission. Furthermore, Ergon Energy supports the comments contained in the Energy Networks Association's (ENA) submission. The ENA is the peak national body for Australia's energy networks, of which Ergon Energy is a member.

In response to the AER's invitation to provide comments on the Issues Paper, Ergon Energy has provided high level responses and directs the AER to QTC and ENA's 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. TABLE OF DETAILED COMMENTS

Question(s)	Ergon Energy Response
<i>Principles based approach</i>	
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?	Ergon Energy supports the inclusion of assessment principles in the rate of return guidelines in order to promote the allowed rate of return objective. However, Ergon Energy considers the principles proposed by the regulator can be improved upon by allowing some amendments and additions to be made. In this regard, Ergon Energy acknowledges and supports the comments made by the ENA and QTC on the proposed assessment principles. Ergon Energy considers the proposed principles should be amended to recognise the interactions between the way in which the rate of return is determined and the debt financing and risk management strategies undertaken by Network Service Providers (NSPs).
2. Are there other principles or criteria which should be considered?	<p>The proposed principles are focussed on the measurement and estimation of the rate of return parameters. However, there are no principles which give consideration to other important issues such as the characteristics of the debt benchmark and the approaches that will be used to determine the annual return on debt allowance.</p> <p>The Australian Energy Market Commission (AEMC) has stated that the return on debt should be determined in a way which creates incentives for all service providers to adopt prudent and efficient debt funding practices. If this is not done it is unlikely that the return on debt will provide compensation for efficient debt financing costs as required by the allowed rate of return objective. Accordingly, Ergon Energy supports QTC's recommendation for the inclusion of the following principle:</p> <p><i>'The return on debt approaches and debt benchmark characteristics are consistent with efficient debt financing and risk management policies.'</i></p>
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?	In Ergon Energy's view, stakeholders have a broad preference for predictability in relation to the return on debt. However, we do not agree that this must be traded off against flexibility. In fact, history would suggest the lack of flexibility in decision making has made WACC outcomes far less predictable in volatile markets. Debt funding practices for long-lived assets have been well established over time and any short-term deviations from established practice are generally in response to changing market conditions. For example, most corporate borrowers were forced to issue debt with shorter tenors during the global financial crisis due to a reduction in the supply of longer-term debt finance. These short-term responses to market conditions are not considered



	<p>to be relevant to the determination of the benchmark return on debt.</p> <p>Ergon Energy supports the ENA submission that the guidelines setting process should aspire to using flexibility in the regulatory framework to improve predictability of outcomes.</p>
<p>4. To what extent should the guidelines set out a pre-determined approach that can then be applied at each determination?</p>	<p>Ergon Energy considers that the guidelines should provide sufficient detail on the process for the AER's decision on a reasonable estimate of the return on equity and the value of the debt benchmark (based on the DNSP's proposal). In this regard, it may be useful for the AER to prepare a straw man rate of return decision process once the guidelines have been finalised to provide an example of how the AER intends to draw upon a wider range of models and data sources when determining the rate of return.</p> <p>The details of the different return on debt approaches that will be considered by the AER at future determinations should be clearly outlined in the guidelines.</p>
<p><i>Key concepts and terms</i></p>	
<p>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?</p>	<p>Ergon Energy acknowledges and supports QTC's detailed response to question 5 and the key concepts and terms proposed in relation to efficient financing costs. Ergon Energy would like to expand upon a number of points from the QTC response which are considered to be of particular importance.</p> <p>Firstly, the monopoly characteristics of an NSP do not extend to the debt capital markets. NSPs, like all borrowers, are exposed to the risk of being unable to refinance their maturing debts on the preferred terms (or at all). The regulated nature of an NSP's revenues or prices does not provide protection against refinancing risk – this risk can only be managed by the debt structures put in place by the NSP. The characteristics of the strategies used to manage refinancing risk, and in particular the staggering of maturity dates and the preferred issuance of long-term debt, should be reflected in the approaches used to determine the return on debt and the characteristics of the debt benchmark.</p> <p>Secondly, the risk management strategies undertaken by all businesses are intended to reduce or eliminate exposure to certain risks. While this may seem like an obvious statement, there are certain risks faced by some NSPs which cannot be managed in practice without increasing exposures to other risks. For example, repricing the base interest rate component of a debt portfolio over a short averaging period once every five years is necessary in order to align the actual debt servicing costs with the return on debt embedded in the allowed revenues. However, an NSP with a large debt portfolio will be exposed to additional risks if they attempt to adopt this practice.</p>



	Ergon Energy considers it inappropriate for regulatory design to constrain the ability for an NSP to effectively manage its risks. The consideration of different return on debt approaches provides an opportunity to remove the constraints inherent in the current approach.
6. Is it still appropriate to separate a conceptual benchmark from its practical implementation?	Ergon Energy supports the use of a separate conceptual benchmark as it provides a useful reference point when gathering information from sources that do not exactly match the benchmark.
7. Does the current definition reflect an appropriate level of detail for the conceptual definition? Are there other factors which should be considered?	Ergon Energy supports the ENA's preferred definition of the conceptual benchmark. Ergon Energy would not support removing the requirement for the benchmark firm to be 'without parent ownership'. It is inappropriate to focus on the risk characteristics of a subsidiary without jointly considering the risks that have either been retained by or transferred to the parent company. A failure to consider these risks is likely to lead to biased estimates of important parameters such as the benchmark credit rating.
8. In relation to the current definition of the conceptual benchmark, is more or less detail preferable?	Ergon Energy considers it may be beneficial for the current definition of the conceptual benchmark to be expanded upon to include more detail relating to the efficient financing and risk management practices undertaken by the benchmark efficient entity. Alternatively, the definition should confirm that the benchmark efficient entity would undertake efficient debt financing and risk management practices.
9. Are the proposed factors reasonable?	Ergon Energy would support consideration of the debt funding practices of unregulated firms, especially those with long-lived assets and similar capital structures to NSPs. The way in which these businesses manage refinancing risk is particularly relevant when determining the characteristics of efficient debt funding strategies. Ergon Energy considers that better estimates of the value of the debt benchmark are likely to be made if a wider range of credit ratings and debt tenors are used. Larger samples may also reduce the potential for disagreement between stakeholders as to whether a particular debt issue should be included in the estimation process.
10. Are there other factors which should be considered?	Refer to response to question 9 above.
11. Are there characteristics that differentiate the level of risk in the gas and electricity sectors, or between distribution and transmission networks?	Nil comments
12. Are there other characteristics that should be taken into account when assessing the level of risk?	The debt funding and risk management strategies that are available to service providers with large existing and new borrowing requirements should be taken into account. However, this does not mean that differential compensation should be provided based on



	the size of a NSP's debt portfolio. The risks faced by large NSPs are <i>created</i> by the way in which the return on debt is currently determined and in particular the assumption that all debt is refinanced and repriced during a short averaging period. The debt funding risks faced by NSPs with different sized debt portfolios should be reflected in the details of the return on debt approaches.
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?	The additional principle suggested by QTC and outlined in Ergon Energy's response to question 2 above is intended to allow all NSPs to use efficient debt funding and risk management practices to align their debt funding costs with the benchmark return on debt allowance. This principle acknowledges that different practices and strategies may be required by different NSPs to achieve a common outcome.
<i>Overall rate of return</i>	
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?	The best estimates of the return on equity and return on debt should be made, with these estimates being combined to arrive at the WACC. If this is what is being referred to as the standard formula (i.e. a weighted average of the cost of debt and the cost of equity) then Ergon Energy would support a continuation of this..
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.	Ergon Energy supports the ENA's position that the list of principles for assessment should not be treated as an absolute 'score card' approach, but rather as a list of considerations upon which the AER decisions should be made, with no one item given prominence or importance over another.
<i>Return on equity</i>	
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?	Refer to Ergon Energy's response to Q15 above. Under such consideration, Ergon Energy agrees the assessment criteria provide an appropriate basis for evaluating the cost of equity methodology.
17. What overall cost of equity methodology best meets the allowed rate of return objective?	The National Electricity Rules (Rules) require that 'regard must be had to the prevailing conditions in the market for equity funds' when determining the return on equity. In practice this is not a straightforward task as the true return on equity is unobservable. However, as the return on equity is a risk-adjusted return, it is reasonable and appropriate for the AER to examine a number of methodologies to ensure it has met the objective. This would include observable risk premiums such as option implied volatilities, the slope of the yield curve and credit margins to make a general assessment as to whether risk premiums are in line with their long-term historical values.
18. What individual cost of equity model best meets the allowed	Ergon Energy considers that there is no single cost of equity model that best meets the



rate of return objective?	allowed rate of return objective, and this view is consistent with the conclusions reached by the AEMC when assessing the previous rate of return framework. It is not open to the AER under the current Rules to adopt one model to the exclusion of all others and conclude it has met the rate of return objective.
19. What other evidence (estimation methods, financial models, market data and other estimates) is relevant to the determination of the cost of equity?	Please refer to the response to question 17 above. Ergon Energy also supports the ENA's proposed three step approach to establishing a cost of equity.
<i>Return on debt</i>	
20. What are the advantages and disadvantages of portfolio approaches compared with the current 'on the day' approach to the return on debt?	<p>The Rules recognise that NSPs should have the opportunity to align their actual debt costs with the benchmark return on debt allowance by implementing prudent and efficient debt financing and risk management strategies. The Rules also recognise that there may be more than one approach to estimating the return on debt if the specific risks faced by service providers are considered. On this basis, the Rules outline three broad approaches to estimating the return on debt that can be considered by the AER:</p> <ol style="list-style-type: none"> 1. The prevailing cost of funds approach; 2. An historical trailing average approach; and 3. Some combination of these two approaches. <p>Approaches (2) and (3) are consistent with the portfolio approach where a staggered maturity profile is used to prudently manage refinancing risk. Ergon Energy supports the use of a portfolio approach to determine the return on debt. However, this should not be restricted to the particular approach implied by the second refinancing practice outlined in the Issues Paper, for the reasons outlined by QTC in their submission.</p> <p>Ergon Energy further acknowledges and supports QTC's detailed submission on the return on debt, including the proposed advantages and disadvantages of the portfolio approach compared to the current 'on the day' approach:</p> <p>A portfolio approach:</p> <ul style="list-style-type: none"> • reduces risk for customers; • reduces the potential for windfall gains and losses; • is consistent with incentive-based regulation; • can reduce the potential for investment distortions; and • will produce an efficient cost of debt. <p>Ergon Energy would like to provide some additional comments on the first advantage listed above. The current 'on the day' approach exposes customers to volatility in the</p>



	<p>cost of debt parameters, which has risen significantly since 2007. This is considered to be a major deficiency with the current approach as it is not in the long-term interests of customers to be exposed to risks that only exist because of regulatory design. A benchmark return on debt which is based on a ten year moving average of the ten year cost of debt will significantly reduce these risks while incurring the same long-term average cost as the current approach.</p> <p>Financial market risks are best managed by the NSPs <i>provided</i> the return on debt approach creates incentives for the NSPs to adopt efficient debt funding and risk management strategies.</p>
<p>21. How do these approaches align with the principles of an efficient financing benchmark, as set out in section 4.2?</p>	<p>Ergon Energy considers that a portfolio approach where maturing debts are regularly refinanced with long-term debt is consistent with the principles of an efficient financing benchmark. That is, an efficiently financed infrastructure service provider can be expected to adopt and maintain a diversified debt portfolio where the total borrowings are spread across several maturity dates out to at least ten years.</p>
<p>22. What are the characteristics of efficient and prudent financing practices that should be taken into account under a benchmark framework?</p>	<p>Please refer to Ergon Energy's response to question 5 above.</p> <p>Ergon Energy considers that the benchmark framework should reflect a portfolio approach to debt management. The framework should recognise that different NSPs have available to them different strategies to manage interest rate risk due to factors such as size. As such the framework should not be limited to a single type of a portfolio approach. To do so would be contrary to the AEMC's position that a 'one size fits all' approach should not be viewed as a default position.</p> <p>Ergon Energy considers that the framework should recognise the appropriateness of funding long-term infrastructure assets with long-term debt. As the underlying debt is likely to be refinanced several times over the life of the asset, it is important for the framework to create incentives to manage refinancing risk. A debt portfolio with diversified maturity dates out to ten years, with maturing debts being refinanced with ten-year debt, is a prudent and efficient financing practice that should be supported under a benchmark framework.</p>