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Dear Warwick

AER Position Paper - Remitted Debt Decisions

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Thank you for the opportunity to comment on the Australian Energy Regulator's (**AER**) position paper in relation to the remitted return on debt decision for Jemena Gas Networks' (**JGN**) 2015-20 access arrangement (**AA**), as well as the NSW/ACT 2014-19 electricity distribution determinations.

We look forward to working co-operatively with the AER through the JGN 2015-20 AA remittal process and the remaking of the AER's final decision as whole which, in addition to debt, includes market expansion capex and an assessment of the revenue true-up.

This submission sets out JGN's feedback on the AER's proposed approach to remaking the debt decisions, including supporting commentary on its interpretation of the Australian Competition Tribunal (**Tribunal**) and Full Federal Court (**Full Court**) decisions.

In making this submission, we would like to affirm JGN's commitment to working collaboratively with the AER and other stakeholders, to finalise JGN's debt remittal as soon as practicable.

AER PROPOSED APPROACH TO THE DEBT REMITTAL

The AER is seeking stakeholders' views on its proposed approach to the debt remittal. Our understanding of the AER's proposed approach to the remittal task, as set out in the position paper, is as follows:

- although the AER's task is to remake its decision on the return on debt in accordance with the directions of the Tribunal and Full Court, the AER considers those decisions provide "limited clear direction" on how it should remake its decisions on return on debt
- the AER has re-evaluated its approach and reasoning since the Tribunal and Full Court decisions - this "process of evolution" is set out in its November 2017 decision on the access arrangement for APA's Victorian Transmission System
- the AER also considers that the October 2017 Tribunal decisions in relation to Jemena Electricity Networks and ActewAGL help to clarify certain aspects of the rules and the scope and interpretation of the Full Court decision, and are therefore relevant
- given those Tribunal decisions, the AER is proposing to rely on its reasoning in the APA decision for JGN's debt remittal.

Following the reasoning in the APA decision, the AER's proposed approach is that a rate of return that meets the allowed rate of return objective (**ARORO**) must provide ex-ante compensation for efficient financing costs and that the Revenue and Pricing Principles (**RPPs**) require it to deliver a NPV = 0 outcome.

The AER considers that a change from the previous ‘on-the-day-approach’ to the ‘trailing average’ approach without a revenue neutral transition will result in an allowed rate of return either above or below the efficient financing costs of a benchmark efficient entity:

We consider a change in methodology is only likely to result in an outcome that meets the ARORO if it results in ex ante compensation for efficiency financing costs and is approximately revenue neutral in a present value sense so that it does not affect the present value of future cash flows through the PTRM model (avoiding windfall gains or losses to the service providers and consumers).

The AER concludes that such an outcome is only achieved if its guideline transition method (“Option 2”) is adopted (see p 3-326 APA decision).

Furthermore, the position paper states that the AER is proposing to apply the guideline transition in exactly the same way as it was applied in the original final determination – that is, with no change to averaging periods, data sources or other assumptions. Consequently, although the reasoning may be different, the return on debt for the first year of the regulatory period would be exactly as it was in the original final decision.

OUR INTERPRETATION OF THE TRIBUNAL DECISION

In JGN’s case, the Tribunal expressed that the remade debt decision for JGN should have regard to its particular position, as set out in direction 1(a):

Having regard to the position of Jemena Gas Networks (NSW) Ltd in its Revised Regulatory Proposal concerning the trailing average approach in accordance with the reasons for this determination;

There are two key elements to this direction:

- first, the remade decision should have regard to the position of JGN in its revised proposal from February 2015, and
- second, the remade decision must be in accordance with the Tribunal’s reasons for its determination for JGN.¹

In preparing this submission, we conducted a further detailed review of the Tribunal and Full Court decisions, examining carefully both the Tribunal’s reasons for its JGN determination and the Full Court’s review of those reasons. To assist the AER’s further consideration of the debt remittal approach, in the paragraphs below we identify some further aspects of the Tribunal’s reasoning that provide additional clarity, and may assist the AER in this debt remittal. Based on our review, we also consider that the more recent Tribunal decisions for Jemena Electricity Networks and ActewAGL do not appear to clarify or alter the reasons and directions of the earlier Tribunal and Full Court decisions.

The assessment framework required under the Tribunal directions

The Tribunal’s reasons require a particular approach to estimating the return on debt:

- the “starting point” should be an assessment of the efficiency of the debt management practices of the relevant service provider at the commencement of the regulatory period, having regard to its risk profile, and
- where these practices are found to be efficient, then the efficient costs associated with maintaining these practices are to be allowed – but if found to be inefficient, an efficient benchmark cost allowance must be imposed instead

Similarly, the Full Court observed that the function of the ARORO is to provide an “efficiency yardstick”, stating that:

¹ As stated in para 82 of the JGN Tribunal decision, these incorporate the Tribunal’s reasons for decision in the Ausgrid proceeding, which was heard by the Tribunal concurrently with JGN and others.

- there is nothing in the relevant rules which requires the actual circumstances of the service provider in question to be ignored
- it is the efficiency of that service provider's costs that is to be benchmarked – according to what would be required by a workably competitive market
- considered against the yardstick of the efficient financing costs of the benchmark, the service provider's debt management practices will either be efficient or inefficient.

Furthermore, both the Tribunal and Full Court formed the view that in this context, “costs” are contractual costs associated with maintenance of an efficient financing practice.

JGN specific circumstances relevant to the remittal decision

The Tribunal's reasons in respect of JGN include a discussion as to whether the AER's guideline transition (“Option 2”) – as applied by the AER in the original final decision for JGN – is consistent with the assessment framework outlined above.

In this regard, a key issue that the Tribunal paid particular attention to was the circumstances of JGN, and the market conditions around the time of the AER's original decision for JGN in June 2015. It was the combination of these specific circumstances that led the Tribunal to conclude that, in the case of JGN, the AER's return on debt should be set aside and remitted.

Of key importance to the Tribunal's reasoning for JGN is that there was a significant drop in the prevailing debt risk premium (**DRP**) around the time that JGN's return on debt was to be estimated. As a consequence of this drop, JGN's return on debt allowance under the guideline transition would be well below the efficient financing costs of a business with similar risk exposure to JGN. The Tribunal stated:

The evidence before the AER, and referred to in submissions, indicated a significant drop in the DRP between the time of the AA Proposal and February 2016. That drop was such that, as JGN contends, the application of Option 2 in the circumstances of a BEE with the risk exposure like that of JGN would mean that the return on debt to be determined would be inconsistent with the RoR Objective itself and with the revenue and pricing principles in ss24(2), (3), (5) and (6) of the NGL.

That is not a matter which the AER appears to have taken into account in the exercise of its discretion. In the view of the Tribunal, it is a matter which the AER should have considered. It is a matter which the Tribunal has taken into account, and as presented, it is a matter which would lead the Tribunal on review to exercise the discretion differently. If the proposition is correct, as it appears on the submissions to be, in the view of the Tribunal the AER could be said to have made a determination which was not consistent with the RoR Objective.²

Importantly, the key issue identified in the reasons of the Tribunal and the Full Court is the application of the guideline transition *in the particular circumstances of JGN*. The Tribunal and Full Court reasons for JGN are not just critical of the reasoning or conceptual framework adopted in the original final decision for JGN – they also identify error in outcome of the reasoning process (i.e. the application of the guideline transition to JGN). The outcome was in error because, in the specific circumstances of JGN, the guideline transition provided an allowance that was below the efficient cost of maintaining a financing practice which the AER had found to be efficient.³

² Extracted from the JGN Tribunal decision, paras 76 and 77. For further details on the significant drop in the DRP, refer to *Jemena Gas Network submissions on framework issues, return on debt and market expansion capital expenditure* (filed in the Tribunal, 20 August 2015), para 171 and Figure 1.

³ Following expert advice provided by Chairmont and Professor Lally – see, for example, AER original final decision for JGN, Attachment 3, p 3-172.

Therefore, simply re-applying the guideline transition to JGN – with the same averaging period and measurement techniques as the original final decision – would not be in accordance with the Tribunal reasoning.

Areas of further focus by the AER

JGN believes that in reaching a draft decision on the debt remittal, the AER should consider further the points we have raised in response to the position paper and:

- have regard to the Tribunal's reasons in its determination for JGN in respect of the application of the hybrid transition ("Option 3")
- directly address the Tribunal's key finding that the application of the guideline transition in JGN's particular circumstances did not account for the sharp drop in the prevailing DRP just prior to JGN's averaging period
- assess whether it will have satisfied the directions of the Tribunal by adopting different reasoning but arriving at the same outcome. As noted above, in JGN's case the key issue identified by the Tribunal in its reasons was in the outcome (the application of the guideline transition), not just the reasoning which led to the outcome
- have regard to the SA Power Networks Full Court decision from January 2018 - although we query the weight that should be placed on this decision, given the Full Court in that proceeding did make it clear that it was not considering the relative merits of the various approaches to debt transition – and certainly does not go so far as to contradict the clear statement made in the earlier Full Court decision pertaining to JGN's specific circumstances (or otherwise suggest in any way that the guideline transition would be appropriate for JGN's particular circumstances).

Based on our review of the Tribunal and Full Court reasoning, the relevant parts of these reasons require a particular approach to be taken to remaking the debt decision. That approach involves starting with the actual financing cost structure of the relevant business as at the commencement of the regulatory period, and assessing whether that is efficient.

Unlike some other service providers, JGN entered the 2015-20 regulatory period with hedging arrangements in place for the base rate component of its cost of debt, but no hedging in respect of the DRP. Taking into account the expert advice of AER advisors Chairmont and Professor Lally, this was considered to be an efficient practice. In such circumstances, the Tribunal's reasons require that the return on debt allowance reflect the efficient financing costs associated with this financing practice that has been found to be efficient. The efficient financing costs associated with such a practice are best reflected in the hybrid transition ("Option 3").

By contrast, the guideline transition – at least as it was applied to JGN, and in light of the circumstances surrounding the original AER decision – provided an allowance materially below the efficient cost associated with this efficient practice. This is the key issue that was identified by the Tribunal in its reasons for decision for JGN.


PROPOSED WAY FORWARD

Many of the issues in this submission and in the position paper have been the subject of extensive consideration and debate in the period from 2015 to date. The environment has been at times challenging, given the various decisions, and the need for re-evaluation of positions following further activity in the Tribunal and the Full Court.

JGN understands the AER's desire to implement a revenue neutral transition that is compatible with the NPV = 0 principle. Of the matters covered in our submission, our primary area of concern is to ensure that the transition is effected in a way that takes into account the JGN-specific circumstances involving the significant drop in prevailing DRP which occurred in the period between JGN lodging its initial AA proposal (June 2014) and its revised proposal in February 2015.

We have outlined in this submission an approach which addresses this, which we consider is in accordance with the Tribunal's reasons. But there may be other ways – and we would be very open to further discussions on this issue, with a view to resolving the remittal as soon as practicable.

Yours sincerely

A handwritten signature in black ink, appearing to read 'Usa', with a horizontal line underneath it.

USMAN SAADAT

General Manager Regulation