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13 February 2015

By mail

Dear Michael

Confidential

AER Draft Decision – cost of debt

We attach a submission in relation the draft decision by the Australian Energy Regulator (**AER**) on the 2014-2019 regulatory proposals submitted by Endeavour Energy, Ausgrid and Essential Energy (**Networks NSW**) in so far as it deals with the application of clause 6.5.2 of the National Electricity Rules (**NER**) to those proposals and matters which may affect the validity of any Final Decision by the AER.

The submission identifies that any final decision by the AER which has a constituent decision on the cost of debt arrived at through the reasoning apparent in the draft decision will be flawed and inconsistent with the NER. Specifically any decision by the AER to implement the transitional arrangements set out in its Rate of Return Guidelines in the determination of the cost of debt of Networks NSW will not be authorised by the National Electricity Law or NER.

The attached submission has been prepared with the assistance of Cameron Moore SC, Banco Chambers and Catherine Dermody, Victorian Bar.

Yours sincerely

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AER Draft Decision – Cost of Debt

1 A significant aspect of the AER's draft decision on the approach to be taken to estimating the return on debt component of the allowed rate of return is the decision to implement transitional arrangements in moving from the current "on-the-day" approach to the new "trailing average portfolio approach".[1]

2 This submission explains in more detail why that aspect of the draft decision is erroneous. It should be read with the relevant parts of the respective Revised Proposals and the materials filed with those proposals.

3 The AER has (correctly) identified the trailing average methodology as the best methodology for measuring the cost of debt. Networks NSW has a long term staggered debt portfolio without substantial derivative hedges seeking to align its debt costs (or at least the underlying risk-free rate component) to an "on-the-day" return on debt calculation. Networks NSW has thus already adopted an approach to financing its debt consistent with the trailing average approach, and the immediate imposition of a trailing average approach would best calculate Networks NSW's efficient financing costs for the forthcoming regulatory period. In these circumstances, there is simply no proper basis for the imposition of a different methodology on Networks NSW through the use of a ten year transition to the trailing average approach. Such an approach will result in a calculation that necessarily will be a less accurate assessment of Networks NSW's efficient financing costs.

4 The AER's draft decision to impose a 10 year transition period is based on a series of errors, as follows:

(a) a misunderstanding as to the proper application of the hypothetical benchmark efficient entity, including the inappropriateness of imposing a transition to deal with a problem or issue that is purely hypothetical and does not exist in reality;

(b) in any event, significant errors of fact in relation to the identification of the appropriate benchmark efficient entity and the position of that entity;

(c) errors as to what is required or permitted under the NER in connection with the imposition of a transition to deal with an alleged over-recovery in a previous period;

(d) factual errors as to the existence of the alleged over-recovery;

(e) errors as to whether a transition is required for NPV neutrality or to avoid sudden changes impacting on consumers;

(f) an overall misapplication of the NER in light of errors (a) to (e).

5 We deal with each of these errors in this submission.

[1] AER Draft Decision: Attachment 3, pp 3-46 and 3-47.

The proper role of the hypothetical benchmark efficient entity

6 The notion of the hypothetical "benchmark efficient entity" is a tool designed to ensure that the relevant service provider only recovers revenue in respect of the efficient conduct of the business in a hypothetical competitive environment, not the inefficient conduct of a business in a monopoly environment. For example, it is a tool to ensure that only efficient expenditure, rather than inefficient expenditure, is recovered from consumers. It is thus a tool for rewarding efficiency and ensuring that consumers are not exposed to monopoly pricing. It is a tool that has to be applied sensibly and rationally and with discretion, rather than dogmatically, in order to achieve the overall national electricity objective. It certainly does not require the entire revenue calculation exercise to be conducted on some hypothetical basis divorced from reality.

7 For example, assume that Networks NSW built a new underground cable 5 years ago using method A, but a more efficient (cheaper) means of building the cable at the time would be to use method B. Assume that as a result of legislative changes, the cable built using method A is compliant but a cable built using method B would not be compliant and would cost $200 million to rectify. Could Networks NSW contend that, although it faced no additional expenditure requirement, a "hypothetical benchmark efficient entity" would now be facing a requirement to spend $200 million and therefore an additional $200 million should be included in allowable revenue? On the AER's approach, the answer would be "Yes". The AER's approach would require the AER to ignore the actual position of Networks NSW (with no statutory obligation) and calculate its revenue solely based on a hypothetical statutory requirement. The AER's approach on the present issue of debt transition is to point to a hypothetical contractual obligation (derivative hedge contracts) as a reason for imposing a transition.

8 This approach is erroneous. The meeting of a putative obligation where none exists does not result in a proper measure of efficient costs.

9 Given that the AER has correctly recognised, in moving to the trailing average methodology, that the efficient financing costs of a benchmark efficient entity with a similar degree of risk as that which applies to Networks NSW is the cost of issuing debt on a fixed rate staggered portfolio basis, and Networks NSW already issues its debt on that basis, there is no requirement in the interests of efficiency or the avoidance of monopoly pricing for imposing a delay in the movement to the best methodology. There is no scope for the positing of a hypothetical scenario of hypothetical contractual obligations preventing the immediate transition to an efficient financing basis where that scenario does not reflect reality. The AER's approach assumes that there is some contractual obligation preventing immediate movement to a return on debt commensurate with efficient financing costs. That is nonsensical where there is no such obligation affecting Networks NSW. The imposition of a delay will not reflect the financing costs of Networks NSW which are already equivalent to the efficient financing costs of the benchmark efficient entity.

10 In this regard, it is relevant to observe that in amending clause 6.5.2, the AEMC stated:

> ... the Commission considered that the long-term interests of consumers would be best served by ensuring that the methodology used to estimate the return on debt reflects, to the extent possible, the efficient financing and risk management practices that might be expected in the absence of regulation.[2]

11 As observed by Frontier Economics, unregulated infrastructure service providers tend to issue long-term fixed-rate debt on a staggered maturity cycle,[3] and obviously do not enter into hedge contracts to fix their debt for five years at the rate prevailing during the

[2] AEMC, *Rule Determination*, 29 November 2012, at p 103.

[3] Frontier Economics, *Cost of Debt Transition for NSW Distribution Networks*, January 2015, p 8, [63].

averaging period. The AEMC's observations, relevant to the proper construction of the NER, have been turned on their head by the approach of the AER.

12 The AER's approach is not in accordance with the NER because it imposes a departure from efficient financing costs, which are those of a fixed rate staggered portfolio. The same efficient financing costs are applicable to a benchmark efficient entity. The AER's approach is thus not in accordance with the allowed rate of return objective in clause 6.5.2(c). That position does not change because of some theoretical contractual obligation that could have been undertaken in a previous period, but which the DNSP did not undertake. That is to posit the wrong benchmark efficient entity for the purposes of clause 6.5.2. Put shortly, the "benchmark efficient entity" is (at most) a more efficient version of the actual entity. The concept of a "benchmark efficient entity" does not require the positing of an entity saddled with statutory or contractual obligations that do not otherwise exist.

13 The AER's draft decision thus results from an error in the proper interpretation and application of the NER.

Additional errors in the identification of the benchmark efficient entity

14 Even if, contrary to the submission above, it was appropriate to consider a hypothetical benchmark efficient entity under hypothetical obligations not reflected in reality, the AER has made factual errors in identifying an appropriate entity.

15 The AER considers that there is a single benchmark efficient entity under the on-the-day approach: that is, that an entity acting efficiently would have acted in only one way. This is despite the fact that the AER acknowledged that "many" debt financing strategies may have been available to service providers under the on-the-day approach.[4]

16 The AER's approach of seeking to establish the characteristics of a single hypothetical efficient benchmark entity, and then analysing issues that might arise for that hypothetical entity, is inconsistent with the rationale for the amendments to the relevant rules. In its 2012 Rule Determination, the AEMC emphasised that:[5]

(a) "efficient benchmark service providers may have different efficient debt management strategies";

(b) "debt management practices tend to differ according to the size of the business, the asset base of the business, and the ownership structure of the business";

(c) there was a problem with the "one-size-fits-all" approach under the existing rules, and that a one-size-fits-all approach should not be considered a default position;

(d) "the regulator could adopt more than one approach to estimating the return on debt having regard to different risk characteristics of benchmark efficient service providers".

17 At the very least, the AEMC Rule Determination emphasises that pursuant to amended clause 6.5.2, the AER may need to consider more than one type of benchmark efficient service provider. This is emphasised in the specification of the rate of return objective in clause 6.5.2(c), which states that the rate of return objective for a DNSP 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 DNSP.* Likewise, clause 6.5.2(k)(4) refers to impacts on a benchmark efficient entity "referred to in the *allowed rate of return objective*" – that is, an entity with a similar degree of risk as that which applies to Networks NSW.

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[4] AER, *Rate of Return Guideline: Explanatory Statement*, December 2013, p 105.

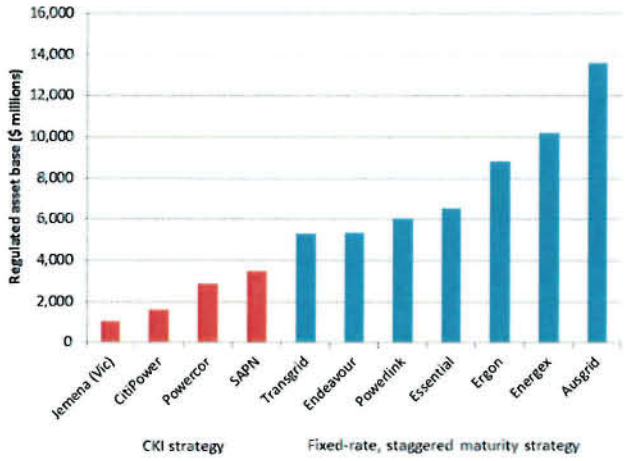
[5] AEMC, *Rule Determination*, 29 November 2012, at pp 84-86, and 90.

18 In amending the rules for estimating the return on debt, the AEMC noted that different regulated entities could have different funding and hedging strategies, which, although different, may each be efficient.

> The Commission intends that there is consideration of the extent to which the methodology used is commensurate with the financing and hedging strategy of the benchmark efficient service provider. This means that there should be consideration of the extent to which the methodology matches the funding costs expected to be incurred by a benchmark efficient service provider over the regulatory period, having regard to the debt arrangements the benchmark efficient service provider is likely to already have in place. This matching is based on the benchmark efficient service provider, but this benchmark could vary with the nature of regulated entities and their efficient funding and hedging strategies.[6]

19 The Frontier Economics report notes that the AEMC has determined that there is no single "one size fits all" efficient debt management strategy and that different service providers may employ different efficient debt management strategies depending on their characteristics and circumstances.[7] The Frontier Economics report notes the comparison of the size of the service providers that adopted the hybrid approach and those that did not, and sets out the following figure:[8]

Figure 4: Service provider debt management strategies under the previous Rules



20 As set out in the Frontier Economics report, the primary evidence suggests that different service providers with different characteristics may adopt different efficient financing strategies, and that the primary evidence suggests that:

(a) for smaller service providers, the benefits of hedging exceed the costs; and

(b) for larger service providers, the costs of hedging exceed the benefits.[9]

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[6] AEMC, *Draft National Electricity Amendment (Economic Regulation of Network Service Providers) Rule 2012 and Draft National Gas Amendment (Price and Revenue Regulation of Gas Services) Rule 2012 – Draft Rule Determinations*, 23 August 2012, p 93.

[7] Frontier Economics, *Cost of Debt Transition for NSW Distribution Networks*, January 2015, p 36, [150].

[8] Frontier Economics, *Cost of Debt Transition for NSW Distribution Networks*, January 2015, p 35, [148].

[9] Frontier Economics, *Cost of Debt Transition for NSW Distribution Networks*, January 2015, p 39, [161] and [162].

The report examines the issue in clear and careful terms, in paragraphs [163] – [190].

21 The statement of Mr Justin De Lorenzo, Group Chief Financial Officer of Networks NSW, confirms that, for so long as he is aware, the Networks NSW businesses have primarily adopted a portfolio approach to structuring their debt portfolios that is consistent with the trailing average approach.[10] He says that, particularly in light of the substantial amounts of debt that need to be refinanced and / or raised in each year to meet the requirements of the Networks NSW businesses, the trailing average approach to managing interest rate and refinancing risks is the most prudent and efficient approach for the Networks NSW businesses.[11]

22 In respect of the 2014-19 period, Mr De Lorenzo states that he considered three possible approaches to the debt portfolios of the Networks NSW businesses.

23 The first was the "matching regime" approach which would endeavour to match the interest rate costs faced by the Networks NSW businesses to the regulatory allowance for the interest rate component of the cost of debt. Mr De Lorenzo found that this would imply a five year fixed rate swap transaction in the vicinity of $25.7 billion which would be too big for the local market and would also incur a very high cost. That is, an out of the money actual cost of debt compared to the expected regulatory cost of debt allowance determined on any basis (trailing average or on-the day).[12]

24 The second approach considered by Mr De Lorenzo was one where Networks NSW continues to manage all existing debt and refinanced debt set to mature by March 2015 under the current staggered portfolio approach, but after March 2015, all new debt and refinanced debt to June 2019 would be hedged via interest rate swaps. Mr De Lorenzo found that this approach would imply a fixed rate swap of around $12 billion over the regulatory period, which Mr De Lorenzo did not consider to be practical or efficient. His conclusion was that this option would deliver a higher cost of debt over the 2014-19 period than the staggered portfolio approach.[13]

25 The third approach considered by Mr De Lorenzo was for the Networks NSW businesses to continue to pursue the portfolio approach which is consistent with the trailing average approach. Mr De Lorenzo found that the portfolio approach is a prudent debt management approach and one which is expected to provider a lower cost of debt than the other debt management approaches over the 2014-19 period.[14]

26 Mr De Lorenzo's statement challenges the broad conclusion of Professor Lally that, under the on-the-day regulatory approach to setting the return on debt, the Networks NSW businesses could and should have hedged using derivative products like interest rate swaps.[15]

27 Professor Lally theorises that perhaps the Networks NSW businesses have not sought to hedge the risk-free rate component of the cost of debt because either they are less aware of the full potential of the swaps market or because they are not subject to normal market signals and incentives.[16] This view is obviously unsound, for the reasons stated by Frontier Economics.[17] Of course, Professor Lally's view is entirely speculative and cannot

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[10] Statement of J De Lorenzo, [9], p 2.

[11] Statement of J De Lorenzo, [10], p 2.

[12] Statement of J De Lorenzo, [21], p 5.

[13] Statement of J De Lorenzo, [22], p 5.

[14] Statement of J De Lorenzo, [23], p 5.

[15] Dr M Lally, *Transitional Arrangements for the Cost of Debt*, 24 November 2014, p 29.

[16] Dr M Lally, *Transitional Arrangements for the Cost of Debt*, 24 November 2014, p 28.

[17] Frontier Economics, *Cost of Debt Transition for NSW Distribution Networks*, January 2015, p 42, [173].

survive a proper examination of the facts. His assessment is incorrect as a matter of fact, and of no weight.

28 The Networks NSW businesses have been, and continue to be, aware of the interest rate swaps market, however, these businesses have determined that given the size of their debt portfolios, the best way in which to manage both refinancing and interest rate risk is through the adoption of a staggered portfolio approach.[18]

29 The Networks NSW businesses have been, and continue to be, subject to incentives and signals in relation to managing their debt portfolios including because each Networks NSW business pays the cost of debt (including the debt risk premium) based on their credit rating as a stand alone business in the market. The debt risk premium charged is called the Government Guarantee Fee and reflects the cost of debt that the Networks NSW business would face in the market based on their stand-alone credit rating.[19] If the Networks NSW businesses did not prudently control their costs of debt, and their operating and capital costs more generally, this would have a negative impact on the credit rating of each of the Networks NSW businesses, which in turn would impact on the cost of debt the businesses would face in the market, and hence the Government Guarantee Fee the businesses would have to pay would increase.

30 To the extent the AER considers that a benchmark efficient entity would have acted in a particular way, the AER must consider whether the particular characteristics of a service provider would mean that it would have acted in that way and that it was open to it to act in such a way. This is clear from the allowed rate of return objective, which provides that the rate of return for a DNSP 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 DNSP in respect of the provision of standard control services.[20]

31 In respect of whether Networks NSW could have hedged the risk free rate component of the cost of debt in the 2009-14 regulatory control period using interest rate swaps (and therefore may have come into the 2014-19 period with fixed rate swaps in place), Networks NSW has provided a report from UBS which notes:

(a) in January 2009, the median standard transaction size for interest rate and cross-currency swaps was A$50m;

(b) AUD interest rate swap annual turnover was $1,561,178 million, which equates to $5,988 million per business day;

(c) The notional debt for the Networks NSW businesses at the time of the 2009 determination was $9,801 million (actual debt was $10,040 million). TransGrid, TasNetworks and ActewAGL had notional debt of $3,461 million and were subject to the same timing in regard to the regulatory determination. The total on the day notional debt amount for the service providers subject to a determination at that time was $13,262 million. Over the term of the 2009-14 regulatory period the appropriate hedge amount was $18,263 million, being the average notional debt amount for each entity over the period.

(d) Based on the median standard transaction size at the time of $50 million, the total hedge requirement for the Networks NSW businesses, TransGrid, TasNetworks and ActewAGL represented 365 times the standard transaction size.

(e) In UBS' opinion, it is reasonable to assume that the service providers may, at that time, have transacted up to $200 million of fixed rate interest rate swaps per day without causing market dislocation or exhausting availability liquidity, and on that

[18] Statement of J De Lorenzo, [28], p 6.

[19] Statement of J De Lorenzo, [36], pp 8-9.

[20] National Electricity Rules, clause 6.5.2(c).

basis, the total notional debt amount may have been hedged in 91 business days. UBS states that they regard that as an aggressive assumption in the context of a median transaction size of $50 million and daily market turnover of $862 million at that time.[21]

32 In UBS' opinion, they consider that any requirement to hedge outside of an averaging period as an unacceptable risk because it would expose the entity to potential material loss.[22] UBS measured the potential risk to the Networks NSW businesses of hedging outside the averaging period that applied to the 2009-14 determination as $819 million.[23]

33 A letter from the Australian Office of Financial Management (**AOFM**), which is based on their experience with transacting domestic interest rate swaps during the period up to mid-2009, highlights the difficulties that the Networks NSW businesses would have faced if they had tried to enter into swap arrangements in respect of the 2009-14 period to hedge the interest rate component of the cost of debt. The letter notes that in November 2008, the AOFM commenced a program to unwind its portfolio of domestic interest rate swaps. AOFM's portfolio at the time comprised 177 swaps with a notional face value of $20.65 billion. The program was largely completed by May 2009, when the AOFM stopped actively seeking terminations. In total, 130 swaps were unwound. The letter notes:

(a) despite the wide spread of maturities (0.18 years to 8.25 years, with an average of four years), market liquidity could "best be described as 'thin' during the onset and immediate aftermath of the financial crisis"; and

(b) executing the swaps in a significantly shorter time period would, in AOFM's view, have been problematic.[24]

34 The amount of debt that would be required to be hedged at the beginning of a regulatory period by any of the Networks NSW businesses is significantly greater than the private service providers that adopt a hybrid approach to managing their debt portfolios. The private service providers identified by the AER as adopting the hybrid approach and an indication of the notional size of their respective debt (by reference to 60% of the value of the relevant regulatory asset base) is set out below.

Regulated entity	**Closing RAB forecast at most recent regulatory determination**	**@60% (assuming debt:equity ratio of 60:40)**
Jemena Electricity Networks[25]	$1,079.8 million[26]	$648 million
Citipower[27]	$1,942.5 million[28]	$1,166 million

[21] UBS, *Response to the Networks NSW Request for Financeability Analysis following the AER Draft Decision of November 2014*, 16 January 2015, pp 2-3.

[22] UBS, *Response to the Networks NSW Request for Financeability Analysis following the AER Draft Decision of November 2014*, 16 January 2015, p 3.

[23] UBS, *Response to the Networks NSW Request for Financeability Analysis following the AER Draft Decision of November 2014*, 16 January 2015, p 3.

[24] Letter from M Bath (Director, Financial Risk, AOFM) to S Knight (Chief Executive Officer, NSW Treasury Corporation), 5 January 2015.

[25] See: Statement of Sim Buck Kim, Head of Treasury, Jemena, [5.25] (undated).

[26] AER, *Jemena Electricity Networks (Victoria) Ltd: Distribution Determination 2011-15*, September 2012, p 28.

[27] See: Statement of Andrew Noble, Senior Treasury Analyst, Citipower and Powercor, [7.1]-[7.3].

Regulated entity	Closing RAB forecast at most recent regulatory determination	@60% (assuming debt:equity ratio of 60:40)
Jemena Electricity Networks[25]	$1,079.8 million[26]	$648 million
Powercor[29]	$3,322.4 million[30]	$1,993 million
SP AusNet (electricity distribution)[31]	$3,358.6 million[32]	$2,015 million

35 The notional amount of debt for which the Networks NSW businesses would have needed to obtain swaps if they had been adopting a hybrid approach to managing their debt portfolios is set out in the table below by reference to the closing value for the regulatory asset bases determined in the 2009-14 regulatory determinations. These amounts are significantly greater than those in the above table, considered either in isolation or in combination.

Regulated entity	Closing RAB forecast at most recent regulatory determination	@60% (assuming debt:equity ratio of 60:40)
Ausgrid	$14,051.1 million (distribution RAB only)[33] $16,363.8 million (transmission and distribution)	$8,455 million $9,818 million
Essential Energy	$7,743.4 million[34]	$4,646 million
Endeavour Energy	$6,068 million[35]	$3,641 million

36 The AER considers that, compared with the alternative possible debt financing strategies, the hybrid approach would have more effectively managed refinancing risk and interest rate risk, and also resulted in a lower expected actual return on debt.[36]

37 In respect of whether the adoption of a hybrid approach will result in a lower expected actual return on debt, what Professor Lally actually says is that such hedging arrangements reduce costs from the 10-year swap rate embedded in their borrowing "to

[28] AER, *CitiPower Pty: Distribution Determination 2011-2015*, p 23.

[29] See: Statement of Andrew Noble, Senior Treasury Analyst, Citipower and Powercor, [7.1]-[7.3].

[30] AER, *Powercor Australia Ltd: Distribution Determination 2011-2015*, p 26.

[31] See: Statement of Alastair Watson, Treasurer for SP AusNet, [5.1]-[5.9], 30 January 2009.

[32] AER, *SPI Electricity Pty Ltd: Distribution Determination 2011-2015*, p 26.

[33] AER, *Statement on Updates for NSW DNSPs Distribution Determination*, p 7.

[34] AER, *Statement on Updates for NSW DNSPs Distribution Determination*, p 6.

[35] AER, *Statement on Updates for NSW DNSPs Distribution Determination*, p 8.

[36] AER Draft Decision: Attachment 3, p 3-115.

the (usually) cheaper five-year swap rate, even after allowing for the transactions costs of the swaps".[37]

38 As noted by CEG, in the final averaging period for the Networks NSW businesses (18 August 2008 to 5 September 2008), the five-year swap rate was 12bppa above the 10-year swap rate (6.79% as against 6.67%). Over the averaging periods originally proposed by the Networks NSW businesses (being 2 June 2008 to 20 June 2008), the five year swap rate was 32bp above the 10 year swap rate and had been negative since mid-2006. In these circumstances, CEG concludes, the Networks NSW businesses would have been correct to assume that there would be "no material interest rate benefits from a hedging strategy that converted base rate exposure from 10 to five year swap rate."[38]

39 Similarly, Deloitte, in a report for the AER had noted that during the period July 2005 – October 2007, there was an 11bps liquidity premium on the five year corporate bond over the 10 year corporate bond.[39]

40 The above point highlights one of the problems in the approach of the AER settling upon only one debt financing strategy that a benchmark efficient operator would have engaged in. The fact is that financial markets are complex and unpredictable, and different entities will take different views about how to structure their arrangements in response to the market conditions that prevail at any particular time and which are forecast into the future.

41 CEG also notes that in circumstances where the debt risk premium component cannot be hedged, if the prevailing five-year swap rate moves inversely to the prevailing 10-year cost of debt, then hedging to the former could cause the cost of debt for a regulated business to move further away from the AER allowance rather than closer to it. That is, CEG states, in such circumstances, differences between the prevailing debt risk premium and the trailing average debt risk premium provide a "natural hedge" to the difference between the prevailing base rate of interest and the trailing average base rate of interest. Hedging using derivatives to the trailing average base rate of interest eliminates the effectiveness of the natural hedge, as do the transactions costs associated with procuring the hedges.[40]

42 CEG concludes that a trailing average approach would have provided a much better hedge (better alignment) to the on-the-day regulatory approach to estimating the return on debt for an averaging period in January 2009.[41] Looked at over the past two regulatory periods, CEG finds that a business undertaking an unhedged (i.e. not using derivatives) approach to managing its debt portfolio would have better replicated the on-the-day cost of debt approach than a business using derivative hedges of the base rate of interest.[42]

43 In relation to the AER's conclusion that the hybrid approach would have been an efficient financing practice of the benchmark efficient entity under the on-the-day regulatory approach to determining the cost of debt because that is the financing strategy that was generally adopted by most private service providers under that regulatory approach, Networks NSW submits that it does not follow that just because most private service providers adopted such an approach, that approach is the only approach which is efficient, particularly having regard to the obvious differences between the relevant private service providers and the larger service providers.

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[37] Dr M Lally, *Transitional Arrangements for the Cost of Debt*, 24 November 2014, p 27.

[38] CEG, *Efficient Debt Financing Costs*, 19 January 2015, [56].

[39] Deloitte, *Refinancing, Debt Markets and Liquidity*, 12 November 2008, p 5.

[40] CEG, *Efficient Debt Financing Costs*, 19 January 2015, [58].

[41] CEG, *Efficient Debt Financing Costs*, 19 January 2015, [64].

[42] CEG, *Efficient Debt Financing Costs*, 19 January 2015, [67].

44 Having regard to these matters, it is clear that the benchmark efficient entity is not the single entity posited by the AER with a hedging strategy of floating rate debt fixed for five years in the averaging period using derivatives.

45 The AER's approach in this regard involves:

(a) an error in the application of the NER in requiring a single benchmark efficient entity, in circumstances where the NER expressly contemplate more than one benchmark entity (clause 6.5.2(c)) and where the extrinsic material makes that plain;

(b) errors of fact as to the efficient strategy under the "on-the-day" methodology; and

(c) errors of fact in specifying the practices of a relevant benchmark efficient entity, being a benchmark entity with a similar degree of risk as that which applies to Networks NSW.

Incorrect approach of perpetuating existing inferior approach to avoid "windfall" gains

46 In relation to the debt risk premium component of the return on debt, the AER correctly observes that this was unable to be hedged under the previous approach and therefore unable to be matched to the regulatory allowance.[43]

47 The AER considers that, if transitional arrangements are not imposed on the debt risk premium component of the return on debt, service providers will obtain a windfall gain in circumstances where their return on debt allowance was set by reference to the on-the-day approach during an averaging period where the prevailing return on debt was higher than the 10 year historical average.[44] The AER believes that a transition is needed to erode this windfall gain. The AER considers that this erosion will occur by virtue of the AER consciously substituting a value for the debt risk premium that is below that which the AER considers that the benchmark efficient entity will face over the forthcoming regulatory period. The AER considers that it is below that which the benchmark efficient entity will face because that entity faces a trailing average cost with respect to the debt risk premium component of the return on debt, which is likely to be higher than the AER's proposed allowance. (Whether it is actually higher in due course depends upon the direction of interest rate movements and DRP movements over the forthcoming period).

48 This conclusion is also couched in terms of promoting NPV neutrality and avoiding potentially undesirable (and unknown) consequences from sudden changes in methodology.[45] Such an approach is unjustifiable. The continuation of the previous "on-the-day" methodology perpetuates an inferior approach that is likely to cause a mismatch between the actual cost of debt and the allowed cost of debt. Those mismatches have occurred in each period in which the methodology has been applied. Whether the allowed funding costs for a particular asset have matched its actual (efficient) funding costs depends upon a fortuitous and random combination of previous unders and overs. To roll the dice again by perpetuating the previous methodology may worsen previous imbalances or mitigate them, and there is no reason why it is more likely to mitigate them (in the same way that a person who has tossed three heads and a tail is equally likely to toss a head or a tail on the next toss of a coin). There is therefore no reason not to proceed immediately to the approach that best matches the actual efficient cost of debt.

49 Likewise, the AER refers to the maintenance of price stability and the avoidance of price volatility.[46] However, these are not factors in favour of the AER's approach. The

[43] AER Draft Decision: Attachment 3, p 3-118.

[44] AER Draft Decision: Attachment 3, p 3-119.

[45] AER Draft Decision: Attachment 3, pp 3-118, 3-119.

[46] AER Draft Decision: Attachment 3, pp 3-122, 3-123.

imposition of a transition arrangement will cause a much more significant decline in the allowed return on debt than would be the case if the AER moved immediately to the trailing average approach, and therefore the immediate imposition of a transition arrangement will cause less price volatility than the approach contained in the draft decision. This is a relevant factor in favour of Networks NSW's revised proposals, and one to which the AER has failed to have sufficient regard.

50 That leads back to the real reason for the AER's approach, which as noted above is to consciously substitute a value below the anticipated cost of debt so as to compensate for a perceived windfall gain by Networks NSW.

51 The AER's proposal is at odds with the November 2012 rule change, which is directed at better matching the regulatory allowance to the costs that would be incurred by an entity engaging in efficient financing practices. As noted by the AER's consultant, with respect to the DRP component of the cost of debt, there is no mismatch between the cost incurred by the benchmark firm and that allowed by a trailing average after the regime change. As such, no transitional method appears to be warranted and, if one was used, Professor Lally says, it would introduce a mismatch that would not otherwise arise.[47]

52 The task of setting a regulatory allowance for a regulatory control period is a forward-looking one. Pursuant to the building blocks approach set out in clause 6.4.3(a) there are only a few specified matters that may have occurred in a prior regulatory period that have any relevance to the calculation of the regulatory allowance in the subsequent regulatory period. There are three discrete matters:

(a) the value of the regulatory asset base;[48]

(b) revenue increments and decrements arising from the application of any relevant incentive scheme;[49]

(c) other revenue increments or decrements arising from the application of a control mechanism in the previous regulatory control period.[50]

53 With the exception of the three matters identified above, the regulatory framework does not operate in a manner that looks back at what has happened in a previous regulatory period in order to calculate the annual revenue requirement for a service provider for each regulatory year of a regulatory control period, in an attempt to capture some prior difference between allowable and actual revenues and costs.

54 The requirement under the National Electricity Law and Rules is to make a distribution determination which, amongst other things, provides the relevant service provider with a reasonable opportunity to recover at least the efficient costs the service provider incurs in providing direct control network services.[51] A distribution determination should also provide for prices or charges for the provision of direct control network services that allow for a return commensurate with the regulatory and commercial risks involved in providing those services.[52]

55 The Rules require that the rate of return for a regulatory control period is commensurate with the efficient financing costs of a benchmark efficient entity. As noted in the Frontier Economics report:

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[47] Dr M Lally, *Transitional Arrangements for the Cost of Debt*, 24 November 2014, p 7.

[48] National Electricity Rules, clause 6.5.1(e).

[49] National Electricity Rules, clause 6.4.3(a)(5).

[50] National Electricity Rules, clause 6.4.3(a)(6).

[51] National Electricity Law, sections 7A(2) and 16.

[52] National Electricity Law, sections 7A(5) and 16.

> ...the allowed rate of return objective provides for the regulator setting the allowed return to be commensurate with the efficient financing costs of a benchmark efficient entity. It does not provide for an exception in cases where the regulator considers that it should set the allowed return to be different from the efficient financing costs of a benchmark efficient entity in order to square up what it considers to be windfall gains or losses from prior regulatory periods.[53]

56 There is nothing in the NER that permits a squaring up in connection with the return on debt. The AER's approach in this regard involves a misapplication of the NER.

57 For completeness, we note that clause 6.5.2(k)(4) permits the AER to have regard to any "impacts (including in relation to the costs of servicing debt across regulatory control periods) on a benchmark efficient entity referred to in the allowed rate of return objective that could arise as a result of changing the methodology...". Such impacts would include an impact on a service provider that did, in fact, have hedge contracts that remain on foot and mean that the service provider's actual cost of debt did not match the trailing average cost of debt. That is not the case for Networks NSW.

58 The Frontier Economics report notes the following problems with the AER's proposal to erode the perceived windfall gain:

(a) The amount of any gain to be eroded or "clawed back" will depend on how many prior regulatory periods are included in the regulator's mental accounting. It is possible that any perceived windfall gain that may have been accrued in the prior regulatory period has already been squared up by shortfalls in prior regulatory periods.[54]

(b) The perceived windfall gains may have been balanced out by other features of the prior regulatory determination. In periods where investors are requiring higher risk premiums on debt investments in the benchmark firm, they will also be requiring higher equity risk premiums in the same benchmark firm. However, the AER's approach has been to use an essentially fixed MRP in its allowed return on equity (and indeed in the context of the 2009-14 determination for Networks NSW, the Rules required a value of 6% to be used for the MRP[55]). Therefore, in periods where risk premiums are at elevated levels, a high debt risk premium (that is, a debt risk premium above the historical average, and which may exceed the debt risk premium that was locked in when the firm issued the debt) may be allowed for, but on the equity side, the MRP is likely to have been set below the premiums that are required by investors. Therefore to the extent the AER considers a benchmark entity may have been over-compensated in respect of its cost of debt in the previous regulatory period, that may have been more than offset by the adoption of a value of 6% for the MRP.[56]

59 Frontier Economics concludes:

> In summary, even if one accepts that the NSW distributors obtained a windfall gain in relation to the allowed return on debt in its prior regulatory period and that it is appropriate to claw back (or square up) that gain with a windfall loss over the current regulatory period, it is not at all clear that adopting the AER's proposed transition period would serve to claw back (or square up) the appropriate amount of prior gains.[57]

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[53] Frontier Economics, *Cost of Debt Transition for NSW Distribution Networks*, January 2015, p 26, [120].

[54] Frontier Economics, *Cost of Debt Transition for NSW Distribution Networks*, January 2015, p 26, [127(b)].

[55] See "transitional chapter 6" which applied to the NSW DNSPs set out in Appendix 1 of Chapter 11 of the National Electricity Rules, clause 6.5.2.

[56] Frontier Economics, *Cost of Debt Transition for NSW Distribution Networks*, January 2015, p 26, [127(c)].

[57] Frontier Economics, *Cost of Debt Transition for NSW Distribution Networks*, January 2015, p 26, [128].

60 CEG is also of the opinion that the setting of rate of return is a task that is prospective in nature.[58] In that context, the CEG report sets out that the economic approach to clause 6.5.2(k)(4) is that the AER must have regard to the extent to which a change in methodology will cause prospective compensation to be different from efficient prospective costs, given the financing strategy that the benchmark efficient entity (efficiently) adopted under the old regime.[59] CEG does not consider that there is anything in the economic regulatory framework that would suggest that clause 6.5.2(k)(4) is designed to operate in a way that would permit the AER to design a new cost of debt methodology (inclusive of transition or not) with the express purpose of imposing a prospective loss on the benchmark efficient entity in order to offset what the AER perceives to be a past gain by that entity that should be taken from it.[60]

Factual errors in the "windfall gain" approach

61 In any case, the proposed adjustment to compensate for a windfall gain is based on factual errors. As noted by CEG, the windfall gain that the AER perceives the Networks NSW businesses have made is not that estimated by Professor Lally, and relied upon by the AER. CEG finds that if the debt risk premium that was determined to apply during the 2009-14 regulatory period is actually used in Professor Lally's analysis, if no transition was applied to the Networks NSW businesses, they are actually undercompensated by 0.82%.[61] This is in contrast to the overcompensation calculated by Professor Lally of 9.53%.[62]

62 The reason for the AER's error is that in his analysis, Professor Lally assumes a prevailing (or allowed) debt risk premium of 4.1%.[63] However, the actual debt risk premium allowance for the Networks NSW businesses for the 2009-14 period, based on the averaging period of 18 August – 5 September 2008, was 3.00%.[64] CEG finds that the prevailing annualised 5 year swap rate (which is the rate that both Professor Lally and the AER assume could and would have been "locked in" by a business using the hybrid debt management strategy), was 6.79%. Given the risk-free rate prevailing at that time of 5.82%, and therefore, a total cost of debt allowance of 8.82%[65], the debt risk premium component of the cost of debt allowance was just 2.03%.[66]

63 CEG performs further calculations which demonstrate that the Networks NSW businesses were undercompensated in the immediately preceding regulatory period, and significantly undercompensated in the preceding 10 years (underscoring the inappropriateness of adopting an approach to square off only the immediately preceding regulatory period). There is therefore no factual basis for the AER's approach, and the approach involves significant factual errors, as well as legal errors in terms of what is permissible under the NER.

64 The above analysis demonstrates the inappropriateness of applying any transitional arrangements to Networks NSW.

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[58] CEG, *Efficient Debt Financing Costs*, 19 January 2015, p 32, [95].

[59] CEG, *Efficient Debt Financing Costs*, 19 January 2015, p 31, [91].

[60] CEG, *Efficient Debt Financing Costs*, 19 January 2015, p 31, [91].

[61] CEG, *Efficient Debt Financing Costs*, 19 January 2015, pp34-35, [105]-[107].

[62] CEG, *Efficient Debt Financing Costs*, 19 January 2015, p 35, [107].

[63] Dr M Lally, *Transitional Arrangements for the Cost of Debt*, 24 November 2014, p 19 (see value of 4.1% in the "prevailing" column for 2009.

[64] AER, *Statement on updates for NSW DNSPs Distribution Determination*, p 2 (Table 2).

[65] AER, *Statement on updates for NSW DNSPs Distribution Determination*, p 2 (Table 2).

[66] CEG, *Efficient Debt Financing Costs*, 19 January 2015, p 35, [106].

AER proposed application of transitional arrangements to Networks NSW not authorised by the National Electricity Rules

65 The AER notes that pursuant to the transitional arrangements, the "chosen risk strategies" that service providers adopted in the past in relation to their financing arrangements are therefore left to run to their "natural conclusion" and they will keep any benefits or wear any detriments that flow from these choices.[67] This statement highlights one aspect of the error that the AER would make if it applied the proposed transitional arrangements to Networks NSW in its final decision. The effect of the transitional arrangements is to in effect delay, or to stagger, the commencement of the AEMC's November 2012 rule change. If the AEMC had intended that the rule that it made in November 2012 would not be implemented for 10 (or more) years, or its implementation would be staggered over a period of 10 (or more) years, the AEMC would have done this via savings and transitional rules in Chapter 11 of the Rules.

66 In the absence of savings and transitional rules that provide for delayed, or staggered, operation of the November 2012 amendments to the return on debt, what clause 6.5.2(c) requires is for a rate of return, which is commensurate with the efficient financing costs of a benchmark efficient entity with a similar degree of risk as that which applies to Networks NSW in respect of the provision of standard control services.

67 The AER is required to apply the National Electricity Rules, as relevantly amended in November 2012 in making its determination for Networks NSW. Clause 6.5.2(c) provides that the rate of return 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 Networks NSW. Having determined that a benchmark efficient entity would adopt the trailing average approach which Networks NSW has historically adopted, there is no relevant impact, including in relation to the costs of serving debt across regulatory control periods, on Networks NSW that arise as a result of changing the methodology for determining the regulatory allowance for the return on debt from the on-the-day approach to the trailing average approach. However, the AER's proposed transition results in Networks NSW's regulatory allowance for the return on debt only being "matched" to what the AER has determined as the efficient benchmark entity's cost of debt from 2025.

68 Simply put, Networks NSW has historically adopted a trailing average approach in structuring its debt portfolio. The AER has determined that such an approach is an efficient approach. The AEMC amended the rules in November 2012 in order to allow the regulatory cost of debt to better match efficient financing costs. The only relevant impact on Networks NSW as a consequence of the change in the methodology used to estimate the return on debt is that it provides Networks NSW with the opportunity to better align its debt portfolio with the regulatory allowance. This is precisely the impact intended by the AEMC's rule change. There is no relevant "impact" in terms of clause 6.5.2(k)(4) on Networks NSW as a consequence of the change in the AER's methodology used to estimate the return on debt and, as such, no transition is required, or authorised, pursuant to the National Electricity Rules or Law.

[67] AER Draft Decision: Attachment 3, p 3-113.