# Better returns for consumers:

## PIAC submission to the AER's Issues Paper – *Rate of return guidelines*

**15 February 2013**

**Bev Hughson, Darach Energy Consulting Services**

**Oliver Derum, Acting Senior Policy Officer**
**Energy + Water Consumers' Advocacy Program**

**Carolyn Hodge, Senior Policy Officer**
**Energy + Water Consumers' Advocacy Program**

Level 7, 173-175 Phillip Street, Sydney NSW 2000 • DX 643 Sydney
Phone: 61 2 8898 6500 • Fax: 61 2 8898 6555 • www.piac.asn.au

## Table of Contents


**INTRODUCTION** ........ **2**
THE PUBLIC INTEREST ADVOCACY CENTRE ........ 2
ENERGY + WATER CONSUMERS' ADVOCACY PROGRAM ........ 2

**1. THE RATE OF RETURN GUIDELINES** ........ **3**
1.1 THE CURRENT REGULATORY FRAMEWORK IS 'OFF-COURSE' ........ 3
1.2 RECENT CHANGES TO THE RULES ........ 5
1.3 IMPORTANCE OF THE RATE OF RETURN GUIDELINES TO CONSUMERS ........ 5
1.4 DIFFICULTIES POSED BY MULTIPLE 'REASONABLE' APPROACHES TO THE RATE OF RETURN ........ 7
1.5 THE IMPORTANCE OF CLEAR OBJECTIVES ........ 8
1.6 OVERALL REASONABLENESS OF THE RATE OF RETURN ........ 9
1.7 RATE OF RETURN GUIDELINES PRINCIPLES ........ 9

**2. AER PROPOSED PRINCIPLES** ........ **10**
2.1 RATE OF RETURN PRINCIPLES SHOULD PROMOTE THE NEO/NGO ........ 10
2.2 PREDICTABILITY VERSUS FLEXIBILITY ........ 13
2.3 THE IMPACT OF THE NON-MANDATORY STATUS OF THE GUIDELINES ........ 14
2.4 EXAMPLE: ASSESSING THE WEIGHTED AVERAGE COST OF CAPITAL (WACC) ........ 15

**3. KEY CONCEPTS AND TERMS** ........ **18**
3.1 EFFICIENT FINANCING COSTS ........ 18
3.2 BENCHMARK EFFICIENT ENTITY – THE 'CONCEPTUAL' DEFINITION ........ 19
3.3 SIMILAR DEGREE OF RISK ........ 21

**4. OVERALL RATE OF RETURN** ........ **22**
4.1 RETURN ON EQUITY ........ 24
4.2 4.3 RETURN ON DEBT ........ 25

**5. OTHER ISSUES** ........ **26**
5.1 APPEALS TO THE TRIBUNAL ........ 26

**6. CONCLUSION** ........ **26**

# 1. Introduction

## The Public Interest Advocacy Centre

The Public Interest Advocacy Centre (PIAC) is an independent, non-profit law and policy organisation that works for a fair, just and democratic society, empowering citizens, consumers and communities by taking strategic action on public interest issues.

PIAC identifies public interest issues and, where possible and appropriate, works co-operatively with other organisations to advocate for individuals and groups affected. PIAC seeks to:

- expose and redress unjust or unsafe practices, deficient laws or policies;
- promote accountable, transparent and responsive government;
- encourage, influence and inform public debate on issues affecting legal and democratic rights; and
- promote the development of law that reflects the public interest;
- develop and assist community organisations with a public interest focus to pursue the interests of the communities they represent;
- develop models to respond to unmet legal need; and
- maintain an effective and sustainable organisation.

Established in July 1982 as an initiative of the (then) Law Foundation of New South Wales, with support from the NSW Legal Aid Commission, PIAC was the first, and remains the only broadly based public interest legal centre in Australia. Financial support for PIAC comes primarily from the NSW Public Purpose Fund and the Commonwealth and State Community Legal Services Program. PIAC also receives funding from the Trade and Investment, Regional Infrastructure and Services NSW for its work on energy and water, and from Allens for its Indigenous Justice Program. PIAC also generates income from project and case grants, seminars, consultancy fees, donations and recovery of costs in legal actions.

## Energy + Water Consumers' Advocacy Program

This Program was established at PIAC as the Utilities Consumers' Advocacy Program in 1998 with NSW Government funding. The aim of the program is to develop policy and advocate in the interests of low-income and other residential consumers in the NSW energy and water markets. PIAC receives policy input to the program from a community-based reference group whose members include:

- Council of Social Service of NSW (NCOSS);
- Combined Pensioners and Superannuants Association of NSW;
- Park and Village Service;
- Ethnic Communities Council NSW;
- Rural and remote consumers;
- Retirement Villages Residents Association;
- Physical Disability Council NSW; and
- Affiliated Residential Park Residents Association.

# 1. The Rate of Return Guidelines

The Public Interest Advocacy Centre (PIAC) welcomes the opportunity to respond to the *Rate of Return Guidelines Issues Paper*[1] (the Issues Paper) published by the Australian Energy Regulator (AER) as part of its Better Regulation project.

PIAC also welcomes the consultative approach adopted by the AER during the development of the Rate of Return Guidelines and the other five new guidelines that form part of the AER's Better Regulation project in 2013.

PIAC believes the consultative approach taken in developing the Better Regulation Guidelines may also provide an opportunity to progressively develop a more collaborative approach to network regulation between network owners, regulators and consumers.

While PIAC supports the aim of greater collaboration, PIAC has concerns about the limited resources available to consumer advocacy groups to respond fully to this reform process in general and to the development of Guidelines in particular. Nevertheless, PIAC looks forward to contributing to the AER's Better Regulation project, which is designed to implement the intent of the National Electricity Rules (NER) during 2013.

This submission outlines PIAC's initial broad comments on: the current regulatory arrangements, including recent changes; the importance of the proposed Rate of Return Guidelines for consumers; the challenges created by multiple 'reasonable' approaches to the rate of return and, the importance of clear objectives. The submission then makes more specific comments and recommendations in response to some questions in the Issues Paper. These cover the proposed rate of return principles, key concepts and terms and the overall rate of return.

## 1.1 The current regulatory framework is 'off-course'[2]

PIAC takes the view, supported by many other reviews[3], that the current regulatory arrangements have not delivered an appropriate balance between the economic interests of service providers and the long-term interests of consumers.

For example, the Productivity Commission identified in its October 2012 Draft Report that network cost increases were at least in part due to 'inefficiencies in the industry and flaws in the regulatory environment' and that the objective of the long-term interests of consumers 'has lost its primacy'.[4]

Analysis of expert reports and the financial statements of the electricity and gas private network businesses further supports the proposition that the network businesses have seen increases in their rate of return over the last few years, which are substantially greater than

1 AER, *Rate of Return Guidelines – Issues Paper,* (2012).

2 Productivity Commission, *Electricity Network Regulatory Frameworks–Draft Report*, (2012), 2.

3 See for example: Productivity Commission, *Electricity Network Regulatory Frameworks–Draft Report*, (2012); Senate Select Committee on Electricity Prices, *Reducing energy bills and improving efficiency,* (2012); AEMC, *Review of distribution reliability outcomes and standards – NSW workstream,* (2012); AEMC, *Economic regulation of network service provider*, (2012); Yarrow, G., Egan, M. & Tamblyn, J., *Review of the limited merits review regime – Interim stage one report* (2012).

4 Ibid, 1–2.

the regulatory outcomes. This is reasonable if it reflects greatly improved efficiency, but PIAC can find no evidence of this. On the contrary, recent network proposals for increased capital expenses and operating expenses per customer suggest the opposite is true.[5]

Moreover, it is clear that components of the AER's determinations, such as the cost of debt, have well exceeded actual market conditions (see page 6 for further details), raising important questions on how the rate of return components are currently calculated and applied.

A major factor in this outcome has been the approach adopted by the AER under the NER and the National Gas Rules (NGR)[6] (prior to the 2013 rule changes) to determine the rate of return.

Perhaps equally important, however, has been the approach taken by the Australian Competition Tribunal (Tribunal) following successful appeals by the networks to the Tribunal[7] for review of almost all of the AER's determinations on the rate of return. [8]

The interplay of the propose-respond model, the AER determination process and the decisions by the Tribunal in over-turning these determinations have been of major concern to consumers in the past. Granting greater discretion to the AER under the new NER and NGR (see below) provides for even more flexibility but potentially greater risk.

It also highlights the necessity, as well as the challenge, facing the AER in developing and implementing the Guidelines in a transparent and analytically robust manner that minimises the merits and judicial review processes and maximises acceptance and cooperation between all the parties.

Major factors in this outcome have been the approach adopted by the AER under the NER and NGR[9] (prior to 2013) to determine the rate of return and, equally importantly, the approach taken by the Tribunal following appeals by the networks for a limited merits review[10] of almost all of the AER's determinations on the rate of return.[11]

---

5 For instance, in the current Victorian Gas Access Arrangement revised proposals for 2013-17, the Victorian gas networks are proposing substantial increases in operating costs and capital expenditure over the five-year period despite customer growth of around 1% and very low gas volume growth. If adopted, this suggests continued declines in network productivity and efficiency.

6 In this submission, reference to the 'rules', means both the NER and the NGR unless otherwise stated.

7 The process for a review of a distribution determination by the AER is set out in s 71B if the National Electricity Law (NGL) and equivalent in the National Gas Law (NGL).

8 This has occurred notwithstanding the AER publishing a Statement of Regulatory Intent on the revised WACC parameters in 2009 in accordance with the old rules (eg. Clause 6.5.4 (c)); a document largely equivalent in its purpose if not its scope to the proposed Guidelines.

9 'The rules' means both the NER and the NGR unless otherwise stated.

10 The process for a review of a distribution determination by the AER is set out in the *National Electricity Act 1996* (South Australia), s 71(B).

11 This has occurred notwithstanding the AER publishing a Statement of Regulatory Intent on the revised WACC parameters in 2009 in accordance with the *National Electricity Rules,* (cl 6.5.4 (c)); a document largely equivalent in its purpose, if not its scope, to the proposed Guidelines.

## 1.2 Recent changes to the rules

For the reasons outlined above, PIAC generally welcomes the changes to both the NER and the NGR introduced by the AEMC in November 2012.

PIAC supports the AEMC's intention to achieve a better balance between network and consumer interests, to give a greater focus to the long-term interests of consumers and to reduce the scope for networks to appeal to the Tribunal for a limited merits review of the determination of the AER.

However, while noting the important progress made in reform of the regulatory framework, PIAC does have concerns as to whether these regulatory reforms will, in practice, lead to better long-term outcomes for consumers.

In particular, PIAC considers that the non-mandatory nature of the new Guidelines,[12] particularly when combined with the propose-response regulatory model,[13] may yet undermine the full achievement of the reform objectives.

These concerns are discussed in further detail below in response to specific AER questions.

## 1.3 Importance of the Rate of Return Guidelines to Consumers

PIAC believes that the development of the Rate of Return Guidelines could play a central part in furthering the overall objective of making network investment and operation work in the long-term interests of consumers. However, as identified above, the non-mandatory nature of the Guidelines may restrict this.

The evidence is mounting that actual returns to network owners are higher, and the cost of debt significantly lower, than that allowed for in the relevant regulatory decisions by the AER for both private and publicly owned networks—particularly following the amendments of the AER determinations by the Tribunal.[14]

This has resulted in economic inefficiency, distorting both efficient investment by network companies and resource allocation by consumers through higher than necessary network costs as suggested by the Productivity Commission and the Carbon Market Economics study and several other recent studies. For instance, Professor Garnaut concludes in his 2011 Climate Change Review that:

> There is an unfortunate confluence of incentives that has led to significant overinvestment in network infrastructure. It is clear from market behavior that the rate of return that is allowed on network investments exceeds the cost of supplying capital

12 See Ibid, cl 6.2.8 (c) and equivalent rule in the NGR.

13 For example, cl 6.12.3 (d) of the new NER obliges the AER to accept a network revenue proposal if it is made in accordance with cls 6.5–6.6. However, many of the requirements in cl 6.5–6.6 are couched in terms of objectives and outcomes rather than specific inputs so are much more difficult to objectively determine if a proposal is compliant with the clauses.

14 The Tribunal's orders reversing the AER's decisions on the Rate of Return components have added a further $2 billion to network charges in the last round of network determinations. See, for example, Productivity Commission above n 2, 201.

to this low-risk investment. The problems are larger where the networks continue to be owned by state governments…[15]

These comments are supported by a variety of other analyses of the actual rate of return being achieved by network owners under the current determination.

For instance, the following table, prepared by Carbon Market Economics as part of the AEMC's rule change process, illustrates the spread of 191 basis points between the estimated actual cost of debt for privately owned networks and the regulated allowance in 2011.[16]

It might well be argued that the spread would be even greater in 2012-13, given the fixed regulatory allowance compared to the decline in actual debt costs since the start of the Global Financial Crisis (GFC).

**Table 1: Differences between estimated and actual cost of debt for selected electricity networks**

| Issuer | Date ASX notified | Term (yrs) | Amount (AUD $m) | Swap rate at date of issue | Spread over swap rate (basis points) | Approx. nominal rate (%) | AER Allowed rate (%) | between AER allowed rate and nominal rate (basis points) |
|---|---|---|---|---|---|---|---|---|
| SPI (Elec & Gas) | 5-Feb-10 | 5.5 | $520 | 5.03 | 152 | 6.55 | 8.81 | 226 |
| SPI (Elec & Gas) | 5-Mar-10 | 10 | $700 | 5.47 | 170 | 7.17 | 8.81 | 164 |
| SPI (Elec & Gas) | 18-Mar-10 | 7.5 | $300 | 5.51 | 160 | 7.11 | 8.81 | 170 |
| SPI (Elec & Gas) | 29-Mar-11 | 10 | $250 | 5.46 | 167 | 7.13 | 8.81 | 168 |
| ETSA | 22-Mar-11 | 5.5 | $250 | 5.19 | 135 | 6.54 | 8.98 | 244 |
| | | | | | Avg. | 6.92 | 8.83 | 191 |

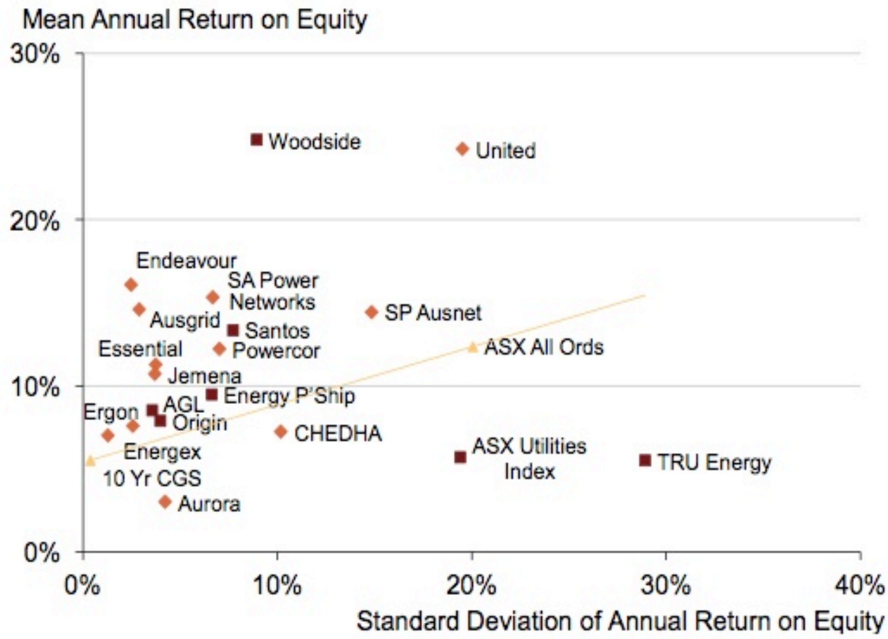
The Gratten Institute provides a more recent comparison of network equity returns and volatility compared to the ASX All Ordinaries and the 10-year Commonwealth Government Securities that further illustrates this point (Figure 1).[17] This analysis demonstrate that the distributors have generally provided higher equity returns with lower volatility than other equity investments.

15 See Garnaut, R, *Climate Change Review-Update 2011, Chapter 11,* www.garnautreview.org.au/update-2011/garnaut-review-2011/chapter11.html as at 6 February 2011,

16 Carbon Markets Economics, *Presentation to the AEMC Public Forum on Network Regulation Rule Change Requests*, (2011), 6.

17 Wood T., Hunter A., O'Toole, M., Venkataraman, P. & Carter, L., *Putting the customer back in front: How to make electricity cheaper,* (2012), Melbourne: Grattan Institute*,* 19.

**Figure 1: Electricity network returns and volatility**[18]




*Sources: Analysis of data obtained from Bloomberg; Standard & Poor's and company reports. Data period: 2004-2011 except where not available from company.*

## 1.4 The difficulties posed by multiple 'reasonable' approaches to the rate of return

One difficulty facing all stakeholders is that the rate of return debate, while critical to regulatory outcomes, is complex and controversial. These are not issues that are readily accessible to consumers, nor is it reasonable to expect consumers to fully discern the impact of alternative approaches on their long-term interests.

For instance, there appears to be a wide variety of expert opinions and regulatory practices on the most appropriate way to calculate each of the rate of return parameters and assess and compare the aggregate rate of return.

Similarly, there are different opinions by economic experts on whether the regulator should adopt a single approach to apply across a class of regulated networks or vary their approach for different network businesses.

Perhaps recognising this difficulty, the AEMC's rule changes have reduced the degree of specification in the rules and provided greater discretion to the AER to develop new guidelines for key areas, including the allowed rate of return.

However, to balance this, the AEMC's rule changes also oblige the AER to conduct extensive consultation with all stakeholders and to draw on multiple expert sources and reputable economic models as part of the development and implementation of these guidelines.

---

18 Ibid.

PIAC considers this a sensible attempt to balance greater flexibility with predictability (see below), with one important caveat that we would seek to explore further with the AER. This is that (unlike the rules) the Guidelines are not mandatory—they do not bind either the AER or any other party.[19] They may be set aside in any given determination, subject only to the party stating the reasons for departing from the Guidelines.[20]

It would seem, therefore, that an individual network could put forward an alternative approach to the allowed rate of return calculation claiming that the Guidelines are not appropriate for their particular situation and a different approach would better meet the allowed rate of return objectives.[21]

PIAC wonders whether the 'reasonableness' of any alternative approach proposed by either the AER or a network would be, in turn, a source of dispute and further merits review. In addition, what role will consumers play in the assessment of such a proposal?

## 1.5 The importance of clear objectives

Given the variety of expert views and the greater flexibility provided to the regulator, it is even more important that the Guidelines, and the subsequent decisions made by the regulator under the Guidelines, are tested against overarching objectives and principles.

The introduction into the rules of the allowed rate of return objective is a promising development, which will provide further guidance to the AER in the development of the Rate of Return (and other) Guidelines. The rate of return objective states that:

> The Rate of Return objective is the Rate of Return commensurate with the efficient financing costs of a benchmark efficient entity with a similar degree of risk in respect to the provision of standard control services.

As acknowledged by the AER in developing the Rate of Return Guidelines, the AER should be able to demonstrate how these Guidelines promote the allowed rate of return objective.[22]

Further, PIAC submits that the purpose of the allowed rate of return objective is to deliver on the National Electricity Objective (NEO) and the National Gas Objective (NGO).

This means that there is a hierarchy of objectives from the allowed rate of return objective to the NEO and NGO. It is these higher objectives relating to the long-term interests of consumers that should be the ultimate goal of network regulation. Without this renewed focus through the Guidelines (et al), the AER will be exposed to criticisms, such as that made by the review of the Limited Merits Review regime, that:

---

19 NER, clause 6.2.8(c)

20 Ibid.

21 For instance, the Guidelines might state that the debt risk premium should be calculated using historical averaging of Corporate bond yields, However, the network might propose a short term averaging, which would lead to quite different assessment of the cost of debt. It is not clear how the AER could reject this proposal if it otherwise complies with clauses 6.5–6.6 of the NER.

22 NER, cl 6.5.2(f).

> [There is] an insufficiency of attention to the National Electricity Objective (NEO) and National Gas Objective (NGO), and hence to the long-term interests of consumers, not only in the LMR process itself but also in business and regulatory decision making prior to the appeals stage.[23]

## 1.6 Overall reasonableness of the rate of return

The AEMC's amendments to the rules, including the allowed rate of return objective, encourages a greater focus on the overall reasonableness of the rate of return outcome.

PIAC believes that the reasonableness of the overall rate of return figure should be part of any determination process. As noted above, a consideration of the reasonableness of the overall rate of return by the regulator is particularly important given the variety of reasonable approaches and the inherent limitations of the underlying data inputs.

Consumers are also hopeful that including both the allowed rate of return objective in the NER and any principles set out in the Guidelines will result in the Tribunal taking a more holistic view of the long-term interests of consumers if it is asked to review an AER determination on rate of return parameters.

## 1.7 Rate of Return Guidelines Principles

PIAC acknowledges the importance of setting out principles in the Rate of Return Guidelines. However, we are concerned that the principles set out by the AER in the Issues Paper[24] appear to be more focussed on the quality of the inputs rather than the validity of the outputs and their relevance to the prime objective of the long-term interests of consumers.

While it is essential that the Guidelines be based on reliable and acceptable inputs, PIAC considers that this is not sufficient to ensure the allowed rate of return objective is satisfied.

In our view, satisfying the allowed rate of return objective should be clearly stated as the *first principle* for the AER to consider in selecting estimation methods, economic models, market data and other evidence[25] for calculating the allowed rate of return.

Moreover, in determining the parameters in the Guidelines, the AER should more explicitly consider the nature of the regulated businesses, the regulatory frameworks they operate in and the risks facing the regulated network businesses *relative to* the general economy and the businesses and households that make this up. For instance, financial commentators refer to the 'sturdy yields and relatively low risks to be found in the regulated utility sector'.[26]

In particular, the broader regulatory framework gives financial protections to networks against sovereign and commercial risks that are generally not available to consumers.[27]

---

23 Yarrow G, Egan M & Tamblyn J, *Review of the Limited Merits Regime, Stage Two Report*, (2012), 6.

24 AER, above n 1, 11.

25 See NER Clause 6.5.2 (e)(1).

26 Macdonald-Smith, A, 'Power companies deliver solid returns', *Australian Financial Review*, 12 September 2012, 7.

27 For instance, the regulatory framework for networks generally allows for the pass-through of certain new costs, force majeure, re-openers, contingency events, revenue adjustments to compensate for demand variations.

Moreover, an efficient regulated network business will have access to insurance, bank credit, interest and currency hedges, rolling debt portfolio and so on that further reduces their risks from (for instance) interest rate exposures. This is captured in the allowed rate of return objective, which specifically refers to the 'efficient financing' of the service provider

Energy consumers, however, will generally have no equivalent ability to manage the risks to their business (or household) of electricity network price increases, particularly increases of the magnitude seen in recent years.

Thus, over-compensation for perceived risk through the allowed rate of return is effectively a transfer of risk from the network businesses (who have tools to manage it) to consumers in general, who do not. This effect is exacerbated where such compensation for risk occurs in the calculation of several of the rate of return parameters and where there is interaction between parameters.[28]

# 2. AER proposed principles

***Q1: 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 than others?***

***Q2: Are there other principles or criteria that should be considered?***

***Q3: 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 ad debt and at the parameter level of the rate of return?***

***Q4: To what extent should the Guidelines set out a pre-determined approach that can then be applied at each determination?***

## 2.1 Rate of return principles should promote the NEO/NGO

PIAC agrees that the development of the Rate of Return Guidelines should be based on a set of principles that promote the allowed rate of return objective and, ultimately, promote the NEO and the NGO for the long-term interests of consumers.

The development of a set of principles is particularly important in the context of the multiple ways that the rate of return parameters could be 'reasonably' calculated and the greater discretion provided to the AER under the new rules (and potentially the network service provider in its initial proposal).

[28] For example, in difficult economic times, the risk free rate may decline (i.e., relatively low yield on safe-haven Commonwealth bonds) while the risk premium may increase. However, at such times, utility bonds (with reasonable gearing levels) may have more the characteristics of the Commonwealth bond than of a commercial bond.

As an example, PIAC refers to the recent paper by the Independent Pricing and Regulatory Tribunal of News South Wales (IPART) on determining the WACC for regulated businesses in NSW.

Table 2 illustrates IPART's summary of various regulators' respective approaches to estimating the cost of debt (one component of the WACC).

**Table 2: Jurisdictional approaches to determining the WACC**[29]

| Regulator | Risk free rate averaging period | Term to Maturity |
|---|---|---|
| Current AER (before Guidelines) | 20-day average | 10- year Commonwealth Government Bond (CGB) |
| IPART | 20-day average | 5-year CGB |
| QCA | 20-day average | 5-year CGB |
| ESC | 40-day average | 10-year CGB |
| ESCOSA | 20-day average | 10-year CGB |
| ERA | 20-day average | 5-year/10-year |
| Ofgem | 10-year trailing average | 10-year index-linked gilts |
| NZCC | Linearly interpolated annualised daily data by Bloomberg | 5-year NZGB |

All these different approaches have some theoretical foundation, and the task of the AER is to evaluate these and other relevant approaches in the development of the Rate of Return Guidelines.

While PIAC supports the use of principles in developing the Guidelines, and accepts that the AER's proposed principles are important, we do not consider the principles set out in the Issues Paper are sufficient to promote the allowed rate of return objective or, more generally, the NEO and the NGO.

The focus of the principles appears to be on the quality of the inputs. For instance, the principles specify the need to use economic principles with strong theoretical foundations, as well as robust and transparent analysis.[30]

PIAC regards these as minimum conditions for stakeholders to have some level of confidence in the reliability of the results. But they are not sufficient in themselves to ensure delivery of the ultimate objective expressed in the NEO and NGO, i.e. to service the long-term interests of consumers.

29 IPART, *Review of method for determining the WACC – Discussion Paper*, (2012), 23.
30 AER, above n 1, 11.

PIAC, therefore, believes that this set of principles needs to be supplemented by an explicit reference to serving the long-term interests of consumers.

***Recommendation 1***

*PIAC recommends that the AER should ensure that the Guidelines deliver a renewed focus on the long-term interests of consumers. The long-term interests of consumers must be explicitly considered and at the centre of regulatory decision making.*

### 2.1.1 Different approaches to determining the WACC

As an example of how the inclusion of this specific requirement in the principles might assist the decision making in the development of the Rate of Return Guidelines, PIAC notes that the new rules provide flexibility regarding the use of either short-term or longer-term historical averaging approaches in assessing the cost of debt.[31] This in turn, as demonstrated in the IPART table above, is an area in which well-reputed experts and regulators disagree – there is no obvious answer.

One option canvassed in the Issues Paper (principle (1)(d)) is that all the methodologies should have regard for prevailing market conditions – which might suggest a preference for the short-term averaging approach.

However, the short-term averaging approach leads to greater volatility and lack of predictability in outcomes, as it is susceptible to short-term swings in market sentiment. This was also illustrated in IPART's discussion paper, as shown in Table 3, below.

**Table 3: Fluctuations in the nominal risk free rate and debt margin over time[32]**

| Parameter | 20 days | 40-day | 5-year | 10-year |
|---|---|---|---|---|
| *Nominal Risk Free Rate (Cth Government Bonds, 5-year maturity)* | | | | |
| Average | 6.3% | 6.3% | 6.2% | 6.1% |
| Standard Deviation | 1.5% | 1.5% | 1.1% | 0.6% |
| *Debt Margin (Bloomberg fair value yield curve BBB rated Aust corporate bonds, 5 year maturity)* | | | | |
| Average | 2.0% | 2.0% | 1.9% | 2.0% |
| Standard Deviation | 1.1% | 1.1% | 0.7% | 0.06% |

PIAC considers that if the AER's principles included an explicit reference to the long-term interests of consumers, then the choice between averaging periods could take account of the impact on consumers of higher or lower volatility between and within regulatory periods.[33]

31 NER, clause 6.5.2(j).

32 IPART, above n 23, 28-29.

33 Noting that the new rules allow the use of a different cost of debt for each year of the regulatory period (cl 6.5.2 (i)) as an alternative to one cost of debt for the whole 5 year regulatory period.

Given that consumers, even large consumers, would find it difficult to hedge network costs (unlike the network owners who can hedge their cost of debt), both large and small consumers may well prefer lower volatility in network pricing, particularly where network prices make up a large component of the final cost of energy.

Cambridge Economic Policy Associates (CEPA) provides a further useful perspective on this issue of decision criteria (or principles) in their 2011 report on the Cost of Debt.

In their report, CEPA proposed a set of evaluation criteria to assist in selecting the most relevant approach to estimating the debt premium (perhaps the most controversial parameter in the calculation of the Rate of Return).

While the list of criteria pre-dates the AEMC's rule changes, PIAC considers that they are still relevant to the current discussion. CEPA's evaluation criteria are:

- **Incentives** – the extent to which the option provides incentives for efficient investment.
- **Cost Recovery** – the option needs to ensure that the risk premium gives the utilities a reasonable opportunity to recover efficient costs and so is financeable. It also needs to take account of the risk of both under and over investment.
- **Consumer interest** – the option should support long-term consumer interests. We take this to mean that prices should be sustainable, i.e. at efficient levels so that services are provided in the long-term without windfall gains for companies. *Further, price predictability is often an important concern, especially when the charge is a significant element of the final price. (PIAC's emphasis)*
- **Consistency** – the extent to which the option differs from existing precedent. This reflects the fact that regulatory risk is likely to be minimised when a track record exists.
- **Practical** – can the option be implemented in practice? This relates both to the establishment of the approach, i.e. are changes to the NER needed, and to the ongoing implementation, i.e. data requirements.[34]

## 2.2 Predictability versus Flexibility

It is clear that there is an unresolved debate between flexibility and predictability that centres on a key issue of whether the AER should:

- adopt a preferred model or approach (such as the Capital Asset Pricing Model (CAPM) for cost of equity) and use other approaches and market data as a check only; or
- consider all reasonable models and market data equally then use their discretion to 'distil' a single number.

Having considered this issue, particularly in the context of the various decisions on appeal by the Tribunal, PIAC accepts that this is a major issue facing the AER exacerbated to some degree by the greater discretion provided under the new Rules.

[34] Cambridge Economic Policy Associates, *Estimating the Debt Margin – Final Report to the Rule Change Sub-Committee of Energy Users Association Australia,* (2011), 4.

The latter approach would appear to provide greater risks in this respect (which models, what weighting, why etc). However, it also appears more consistent with the intent of the new Rules.

PIAC would be concerned if additional flexibility led to regulatory decision making that appears arbitrary and confusing to stakeholders. PIAC submits that consistency in key aspects of the approach, at least within a round of network price determinations, would be desirable for investors, lenders and consumers alike.

PIAC, therefore, submits that further analysis of this issue is required, taking into account the conclusions of the Tribunal, to affirm that the AER can and should use its discretion, but do so with rigour and transparency.[35]

## 2.3 The impact of the non-mandatory status of the Guidelines

PIAC has a particular concern with the fact that under the new rules, compliance by the AER, or any other party, with the Guidelines (including the Rate of Return Guideline) is not mandatory.[36]

This means that even were the Guidelines to provide predictability in principle, they may not, in practice, deliver the level of predictability that consumers would prefer.

In particular, Clause 6.2.8 (c) of the NER (and equivalent clauses in Chapter 6A and rules in the NGR), states that:

> Except as otherwise provided in this Chapter, a guideline is *not mandatory* (and so *does not bind the AER or anyone else*) but, if the *AER* makes a distribution determination that is not in accordance with the guideline the AER must state, in its reasons for the distribution determination, the *reasons for departing from the guideline*. (*PIAC emphasis*)

The new rules appear to provide significant scope for both the AER and a network submitting a proposal for a determination to adopt a different methodology to that set out in the new Guidelines, with an obligation only to provide the reasons for the change.

Reasons can always be found by well-resourced entities for their business to be subject to unique circumstances that warrant variation from the Guidelines.

While such reasons can be couched in terms of achieving the allowed rate of return objective, variation from the approaches set out in the Guidelines can lead to very different outcomes in the overall allowed rate of return, and therefore has the potential to introduce considerable uncertainty about the final outcome.

[35] For example, the Tribunal concludes (with respect to the AER's discretion in calculating a rate of return) in Application by United Energy Distribution Pty Ltd [2012] ACompT1 @46: 'The Tribunal emphasises that it is important for the AER to estimate the DRP and other WACC components with rigour and transparency, using comprehensive market-accepted data and offering some degree of certainty about the way in which it will apply the various estimating formulae (including the DRP formula) to a regulated company. Its estimating practices, data sources and reference periods must be well articulated, consistent and communicated to the parties and must, generally speaking, follow the precedents well-established in previous decisions made by the Tribunal in Application by ActewAGL Distribution and Application by Jemena Gas Networks (NSW) Ltd (No 5).'

[36] NER, cl 6.2.8 (b)–(c).

***Recommendation 2***

*PIAC recommends that the AER address the uncertainty created by the non-binding nature of the Guidelines and other regulatory instruments to minimise the scope for future dispute and appeals.*

### 2.3.1 Challenges for residential consumer groups

PIAC is concerned about the further resourcing demands that will be placed on consumer advocacy organisations to debate the alternative approaches through the determination, and potentially, the appeals process. This will challenge the ability of the organisations to fully represent and defend outcomes that promote the long-term interests of consumers.

PIAC would, therefore, like to see other stakeholders commit to adhere to the Guidelines, accepting the outcome of the consultation processes. If this can be achieved, then progress will be made towards the development of negotiated regulatory outcomes. As the AER Chairman said in December 2012:

> In many respects, the regulatory bargain between the Regulator and the network businesses represents a long-term contract with customers.[37]

However, as welcome as this situation would be, it also requires that the AER's consultation process itself is both transparent and thorough.

PIAC also notes that consumer advocacy organisations, which traditionally face resource challenges, may need to allocate further resources to the debate over whether Guideline or alternative methodologies should be used, and any subsequent appeal for review. It should also be noted that engaging in either this debate, or any resultant process of review, would require high-level economic skills and significant financial resources that are not easily accessed by those representing residential energy consumers.

PIAC submits that the question remains whether this balance between flexibility and predictability is achieved by the Guidelines, given their non-mandatory nature, the limited framework to assess variations from the Guidelines against the NEO and NGO and the lack of a specific reference in the principles to the long-term interests of consumers.

## 2.4 Example: assessing the Weighted Average Cost of Capital (WACC)[38]

Both the previous rules and the new rules in Chapter 6 of the NER state that the rate of return will be calculated on the basis of the nominal post-tax WACC and consist of two components, the cost of debt and the cost of equity (Clause 6.5.2 (b) and clause 6.5.2 (d) respectively for the old and the new NER).

---

37 AER, *Better regulation program: Consultation strategy, Andrew Reeves' public forum presentation,* 18 December 2012, 2.

38 The discussion herein refers to clauses in the NER Chapter 6, which apply to the provision of standard electricity distribution services. Similar clauses apply to the new rules for electricity transmission (in Chapter 6A) and to the Natural Gas Rules (rule 87). PIAC notes that the previous rules in Chapter 6A for electricity transmission services and for gas networks differ in their specificity, the former being more specific and the latter less specific than Chapter 6 of the NER. The AEMC's rule changes have aligned all three with respect to the rate of return.

However, the old rules then provide more specific requirements; for example, the specific formulas for WACC and its components (NER Clause 6.5.2 (b)) and the use of the annualised yield of 10 year Commonwealth bonds for the calculation of the nominal risk free rate (NER Clause 6.5.2 (c)).

In contrast, the new rules focus on achieving the allowed rate of return objective, having regard to such factors as the relevant estimating procedures, financial models, market data and other evidence, the desirability of consistency in financial parameters and the recognition of inter-relationships between parameters (new Clause 6.5.2 (b) – (e)).

For the cost of equity, the new rules direct that regard must be had for ‘prevailing market conditions’ (Clause 6.5.2 (g)).

For the cost of debt, the new rules provide flexibility to use same results over the 5-year determination period or have different results for each year (Clause 6.5.2 (h)).

Similarly, the new rules provide flexibility to determine a cost of debt as if it was raised at the time of the determination or raised over an historical period prior to the commencement of the determination or a combination of both (Clause 6.5.2 (j)).

These differences in averaging periods can lead to considerably different outcomes for the cost of debt. Even apparently small changes to the averaging period can significantly alter the outcome as illustrated in the revisions ordered by the Tribunal to the AER’s NSW network determinations in 2009.[39]

Table 4, below, originally presented by the Productivity Commission in their 2012 Draft Report illustrates the impact the relatively small changes in the averaging period had on the final revenue outcomes.

39 The NSW networks all appealed the AER’s decision on the Risk Free Rate, their argument being centred on AER’s right to replace their proposed averaging period. See Australian Competition Tribunal, Application by EnergyAustralia and Others (No 2) [2009] ACompT 9, 25 November 2009.

**Table 4: Impact of limited merits review decisions on the WACC[a, 40]**

| *Business* | *Year* | *Focus of review* | *Increase in revenue allowance* | *Increase as a percentage of allowed revenue* |
|---|---|---|---|---|
| | | | **$ million** | **%** |
| Integral energy | 2009 | Risk free rate | 338 | 9 |
| Energy Australia | 2009 | Risk free rate | 945 | 11 |
| Country Energy | 2009 | Risk free rate | 467 | 8 |
| Transend | 2009 | Risk free rate | 80 | 8 |
| Transgrid | 2009 | Risk free rate | 374 | 10 |
| Energex | 2010 | Gamma | 288 | 4 |
| Ergon | 2010 | Gamma | 200 | 3 |
| ETSA | 2010 | Gamma | 246 | 6 |
| SPI Ausnet | 2011 | Gamma & DRP | 31 | 1 |
| Citipower | 2011 | Gamma & DRP | 31 | 3 |
| Powercor | 2011 | Gamma & DRP | 58 | 2 |
| United Energy Distribution | 2011 | Gamma & DRP | 41 | 2 |
| Jemena | 2011 | Gamma & DRP | 31 | 3 |
| Total | | | 3183 | 8 |

[a] DRP is the debt risk premium (discussed above), Gamma is the assumed utilisation of imputed tax credits

*Source*: CME (2012).

Given the flexibility inherent in the formulation of the new rules as discussed above, an immediate purpose of the Rate of Return Guidelines should be to provide some certainty to stakeholders to counterbalance the additional flexibility under the new rules.

It would do so by setting out the AER's views (based on extensive consultation) on how best to calculate each of the allowed rate of return components to achieve the allowed rate of return objective.

For example, the AER may state in its Guidelines that the return on debt should be based on a historical averaging period of 5 years. This does not, however, preclude a network proposing an alternative averaging period providing they explain their reasons. It appears to PIAC that the onus of proof will then be on the AER to establish why this is not reasonable of consistent with the allowed rate of return objective.

40 Productivity Commission, above n 2, 201.

# 3. Key Concepts and Terms

***Q5: Apart 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.***

***Q6: Is it still appropriate to separate a conceptual benchmark from its practical implementation?***

***Q7: Does the current definition reflect an appropriate level of detail for the conceptual definition? Are there other factors which should be considered?***

***Q8: In relation to the current definition of the conceptual benchmark, is more or less detail preferable?***

As highlighted in the AER's Issues Paper, the allowed rate of return objective, which is central to the new regulatory approach, draws on a number of concepts that require further clarification.

PIAC provides some high-level comments below on these important questions, and welcomes further clarification of these particular issues over the course of the Better Regulation project.

## 3.1 Efficient Financing Costs

The allowed rate of return objective requires the AER to consider, in the first instance, the criteria for efficient financing of the benchmarked business.

Given the complex ownership and debt structures of many of the regulated businesses it is dangerous to rely too heavily on actual practices as they largely reflect the financing strategies of the broader corporate business world.

However, at least amongst the private sector network companies, there do appear to be some consistent themes emerging that go beyond their approach to gearing and perhaps indicate the direction of an efficient financing strategy for a network business. These include:

- shifting more to a portfolio approach using different debt instruments, sources of debt (including overseas debt providers), and different maturity periods;
- shifting the portfolio as a whole to longer-term debt financing arrangements more aligned to the long term, low risk nature of the assets;
- roll-over of high cost debt early (before maturity date) to gain access to better interest terms; and
- expanded use of hedging instruments, including hedging for inflation, interest rates and currency risks.

As a typical example of the above financing strategies, Envestra's 2010/11 Annual Report presentation highlights the following capital management steps adopted over the last few years to improve their financing position, including:

- reduction in ratio of debt to RAB [regulatory asset base] from about 1.05 to 0.74 (2011);
- extending the average term to maturity to around 11 years;
- 85% of interest exposure hedged at 30 June 2011;

- lower interest rates over new hedges through each regulatory re-set;
- proactive management of the debt portfolio, using a variety of instruments such as commercial paper, banks, US Private Placement; and
- roll-over of higher interest debt to lower interest debt.[41]

PIAC believes that these strategies (taken at a high level) provide guidance to the efficient financing approaches adopted by a private sector utility company and should be included in the assessments of this concept by the AER.

They are, of course, also relevant to the issue of risk allocation raised in previous sections of this submission as they indicate some of the risk management tools available to network companies.

***Recommendation 3***

*PIAC recommends that the AER consider the efficient financing approaches for a private sector utility listed above, when considering the possible adoption of a benchmark efficient firm for the purposes of the Rate of Return Guideline.*

## 3.2 Benchmark Efficient Entity – the 'Conceptual' Definition

As noted in the current Issues Paper, in its 2009 review of the WACC parameters,[42] the AER identified two distinct requirements for defining a benchmark efficient service provider. The AER considered that these were:

- The *conceptual definition* – which is guided primarily by the objectives of the incentive regulation regime
- The *practical implementation* of this definition – there are few or no service providers that exactly meet this definition. It is pragmatic, therefore, to consider a wider range of evidence…[43]

The 2009 WACC review paper established the conceptual definition as follows:[44]

> A 'pure play' regulated electricity [or gas] network business operating within Australia without parent ownership.

PIAC believes that it is still appropriate to separate a conceptual definition benchmark from its practical implementation because the circumstances of their being few providers that meet the conceptual definition is as true today as it was in 2009.

Nor does PIAC see much value in extending the conceptual definition given its inevitable abstract nature—'short and sweet' is better in these circumstances.

However, this also means that the AER should be very clear in each determination about this distinction, seek to match the practical with the conceptual as closely as possible and provide the reasons why they have adopted the range of entities that they have in any given benchmark assessment.

---

41 Adapted from Little, I and May, P, *Envestra Limited – Full Year Results* (2011), 14–15.
42 AER, *Final decision, Electricity transmission and distribution network service providers Review of the weighted average cost of capital (WACC) parameters*, (2009), 34.
43 AER, above n 1, 13.
44 Cited in ibid, 14.

### 3.2.1 Practical implementation of an efficient entity benchmark

The AER, while noting the need for flexibility for individual network circumstances, provides some suggestions on guiding factors, including:[45]

- a preference for large samples over close matches to the benchmark;
- the use of observed market practices, i.e., the rate of return should reflect the 'observed behaviour' of actual regulated firms, such as raising debt in staggered increments; and
- wider ranges for credit ratings and benchmark terms for debt.

PIAC generally supports the use of observed behaviour of current regulated firms as a guide to the efficiency benchmark, even when the circumstances are different than those set out in the conceptual definition.

However, experience indicates caution should be exercised with respect to the other two guiding factors. Simply adding more entities to the sample may make the data more statistically reliable but may also make the comparison less valid. Similarly, adding firms beyond the current BBB+ criteria may lead to biases in the rate of return estimates.

As noted previously, caution is also required in providing flexibility for individual networks. Such flexibility incurs the risk of protracted debate of the 'my business is different' type that can undermine the success of benchmarking in driving efficient outcomes.

More generally, the 'guiding factors' should *not* enable the arbitrary selection of businesses for inclusion in the benchmarking exercise. Indeed past decisions of the Tribunal indirectly suggest that even with the change in rules, the Tribunal will find against the AER if the AER has not provided adequate justification for any particular selection of benchmark entities.[46]

Nevertheless, it is difficult to comment at this stage on the question of how wide the AER should cast its net for the purposes of practical benchmarking of an efficient firm. Clearly the objective should be to strike a balance between reliability (larger samples) and validity (relevant samples).

It may be that this discrepancy between the conceptual ideal and the practical implementation of the benchmark evolves over time. Certainly, the progressive development of relevant performance data and of industry benchmarking processes and methodologies (a separate stream of AER activity), will assist in providing the best combination of entities for benchmarking an efficient firm.

---

45 Ibid, 15-16.

46 For example, in the AER's determination of the DRP component of the WACC for the Victorian Electricity Distribution businesses and in their determination for the Jemena's NSW gas network, the AER included Australian Pipeline Trust's (APT) 10-year bonds as well as the extrapolated Bloomberg 7-year yield curve. The AER argued (inter alia) that as APT was a gas pipeline operator, with BBB credit and risks arguably greater than the electricity businesses (because of its transmission exposure) and more comparable than the average of the companies in the Bloomberg fair value curve, it was a fair, perhaps conservative measure of the market costs of debt and therefore should be given some weight in the DRP estimate. The Tribunal did not accept the inclusion of the APT bonds in either case. See: Application by Jemena Gas Networks (NSW) Ltd (No 5) [2011] ACompT 10; and Application by United Energy Distribution Pty Limited [2012] ACompT 1.

## 3.3 Similar Degree of Risk

PIAC submits that an objective analysis of the risks faced by each of the sectors (distribution, transmission, electricity and gas) should underpin much of the analysis of the allowed rate of return.

The new rules remove the previous requirement under the National Electricity Law (NEL) to use a parameter, Beta, to measure exposure to systematic risk in the CAPM that was in turn used to calculate the return on equity.

There is no such requirement for either Beta or CAPM in the current rules – this is left to the discretion of the AER, subject to appropriate consultation and investigation.

More generally, PIAC considers that the AER must carefully investigate the nature of the risks that apply to a regulated entity, and ensure the modelling produces outcomes consistent with market observations on relative risk.

Risk can arise in a number of ways and their treatment within the allowed rate of return framework should reflect this. For example:

Financial and Commercial Risks:

- risks of interest rate movements above the rate set in the cost of debt component of the determination;
- step change economic events such as the Global Financial Crisis which effect the availability and cost of capital and equity;
- non-diversifiable risk in the rate of return on equity (previously captured through the Beta coefficient); and
- risks that actual demand will vary from forecast and impact adversely on total revenues and return on assets.

Operational and Regulatory Risks:

- risks that are under the control of the business (e.g. Health & safety, environmental management);
- external events (e.g. extreme weather events) that can be reasonably predicted through probabilistic modelling (for instance) and/or where an efficient business can adopt effective risk management strategies; and
- risks of regulatory or policy changes that impact on costs and revenues.

These are all risks that are faced most businesses, particularly infrastructure businesses with large fixed capital costs and capital investment requirements.

It is reasonable to ask, therefore, which other entities can be identified as bearing a similar risk profile to the regulated electricity and gas networks.

In PIAC's view, this question cannot be answered without reference not only to the risks, but also to the risk mitigation tools available to the respective entities.

For example, the networks' regulatory framework provides a number of protections to the network businesses compared to other infrastructure entities. These include:

- protections against  revenue loss from variations in actual demand compared to forecasts (particularly for those network businesses subject to a total revenue control mechanism); and
- the availability in the regulatory framework of pass-through allowances (including cost recovery for implementing regulatory changes[47]), contingency events, force majeure and, under some circumstances, the re-opening of the determination.

Many of the other infrastructure entities (such as roads or telecommunications) do not have access to all these risk mitigation arrangements. These differences must, therefore, be taken into account if these companies are to be used as part of the benchmarking process.

In addition, a number of the stated risks are 'two-way' risks. For instance, demand might be higher than forecast or lower. It may be unreasonable to allow compensation for the down-side events but not corresponding recovery when there is up-side events.

Finally, PIAC notes that the long-term interests of consumers are not served by transferring risk of network price increases and volatility to consumers, particularly where consumers are less able to efficiently manage these risks.

***Recommendation 4***

*PIAC recommends that the AER undertake a full review of the comparative risks and availability of risk management tools before the allowed rate of return is calculated.*

# 4. Overall rate of return

***Q14: 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?***

***Q15: How can overall rate of return consideration 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.***

The calculation of the allowed rate of return from its component parts is complicated not only by the multiple approaches to assessing the parameters that are based on an established economic theory (as discussed previously) but also by the lack of data available for the analysis of the individual components. For instance, throughout the last round of network determinations by the AER there has been continued dispute regarding the most appropriate way to measure the debt risk premium (DRP), a key component of the WACC.

The networks have variously argued for the Bloomberg Fair Value curve and  the Bloomberg Fair Value Curve averaged with the CBASpectrum fair value curve. The AER has argued for

[47] For instance, in January 2013 the AER recently approved an application by ActewAGL Distribution for a pass through of the costs of implementing the National Energy Customer Framework (NECF) adding an additional 1.065% to ActewAGL's 2011-12 annual revenue requirement.

CBASpectrum, Bloomberg and Bloomberg averaged with APT 10 year bonds. The Tribunal has also taken a number of positions on this, generally concluding that the AER has erred in the exercise of its discretion.[48]

By the end of the latest rounds of network price determinations there appears to be some convergence by the regulator and networks around the use of the extrapolated Bloomberg 7-year yield curve despite its limitations, although the way is clearly left open for further investigation.

However, during the course of the arguments, many questions have been raised about the use of the Bloomberg curve itself, particularly the lack of transparency, the reliability of the data and the need to extrapolate from 7 years to 10 years to align with the AER's 2009 Statement of Regulatory Intent.

Moreover, as highlighted by the AER[49] and the Energy Users Association of Australia,[50] the extrapolated Bloomberg fair value curve has generated estimates for 10-year maturity bonds that seem to be significantly higher than the bonds issued by the private sector network businesses over the last few years.

In addition, it is acknowledged that there are interactions between the parameters and the new Rules that require these values to be taken into account in the calculation of the allowed rate of return.

However, these interactions are difficult to capture empirically or quantify mathematically to a precise point, again requiring the exercise of judgement.

Given all these factors, PIAC regards it as essential that the AER compares the rate of return that is derived from the sum of its components to an aggregate rate of return derived from observations in the 'real world'.

However, there is a further issue regarding the status of the 'real world' analysis of the aggregate rate of return in the determination process.

Is the AER's market-based assessment of the aggregate allowed rate of return a guide only? Or can it be used to replace a rate of return proposed by a network if that proposal reasonably complies with the calculation of the individual parameters set out in the Rate of Return Guidelines? PIAC is unclear on this issue, and therefore seeks clarification from the AER.

The amended Rules require the AER to make a determination that is consistent with the allowed rate of return objective that, in turn, refers to the efficient financing of a benchmark efficient service provider.

---

48 A comprehensive discussion on these issues and key Tribunal decisions can be found in AER, *Victorian distribution determination - Final decision 2011-2015,* (2010), 484-514.

49 Ibid 498.

50 For example, see Mountain, B, *Analysis of the Australian Energy regulator's assessment of the Debt Risk Premium in its Draft Decision on price controls for the period 2011/11 to 2015/16 for the Victorian electricity distributors – A report of the Energy Users Association of Australia*, (2010).

This would suggest that an aggregate allowed rate of return, based on some form of efficiency benchmarking, should be the primary determinant in the decision.

However, previous decisions by the Tribunal on appeal, particularly with respect to the DRP, suggests that the Tribunal will require a very high standard of proof, albeit in an area where there are many more opinions than facts, that goes beyond market-based observations[51].

For instance, the Tribunal might conclude that (a) the network proposal was 'reasonable' in the circumstances and/or (b) the AER has not established that its preferred aggregate, market based assessment is preferable (particularly given the limitations of benchmarking).

## 4.1 Return on Equity

The principles set out in Section 3.1 the Issues Paper[52] do provide a basis for the assessment of the reliability of different methodologies for calculating the inputs and determining the appropriate models for the calculation of the return on equity.

This reliability is particularly important when the models (such as CAPM) require single point estimates of the input parameters but may have limited data to support a single point estimate (rather than a range).

However, improving reliability of the modelling approach does not, in itself, guarantee the validity of the model outputs with respect to meeting the allowed rate of return objective. The reasonableness of the outputs of the models with respect to the allowed rate of return objective should first be tested against real world market data.

PIAC also considers it important that the model(s) demonstrate a capacity to reflect changing market conditions as well as long-term returns on equity (as currently used to derive the market risk premium). In addition, the models should deal appropriately with the special characteristics of regulated utilities from an equity investor's perspective, which includes revenue stability and growth through capital investments.

For example, it appears that volatility in the Australian share market and in average shareholder returns since the GFC has seen investors look to the security of regulated assets with lower levels of risk. While the beta values that feed the CAPM model are intended to capture this lower risk, it may not do so adequately in times of high market volatility. That is, a lower beta may be more applicable given the changed relativities between the risks of investing in a regulated network versus investing the equity market in general

51 In the 2011 review of the appeal by Jemena Gas Networks (Application by Jemena Gas Networks (NSW) Ltd (No 5)[2011] ACompT 10) the Tribunal rejected the AER's decision to combine the Bloomberg and CBASpectrum yield curves. The Tribunal emphasised (88) that there was no unambiguously correct way to determine the best curve saying 'the curves must be subject to the ultimate test – that of the relevant data' (88). However, in the 2012 decision on appeal by the Victorian distribution businesses, the Tribunal rejected the direct use of additional data, the APT yield curve. (e.g. Application by United Energy Distribution Pty Limited [2012] ACompT 1), suggesting in its conclusions to this review that the Tribunal will set a very high demanding standard for the selection of market data by the AER, if the AER is to succeed in rejecting a proposal by a network (387–465).

52 AER, above n 1, 11.

Further, throughout 2012 various economic commentators were pointing to the value of both equity and debt investment in regulated utilities. For instance, in September 2012, the Energy and Resources writer for the Financial Review has noted that:

> Just as they are on the Monopoly board, electricity and gas networks are solid investments, and particularly when markets turn shaky…
>
> The utilities sector was a star performer in the 2012 Financial Year as market confidence waned, the benchmark utilities index growing 11 per cent against an 11 per cent dip in the broader ASX 200 index.[53]

The approach to assessing the return on equity, including the selection of the most appropriate financial model(s), needs to recognise this complexity.

## 4.2 Return on Debt

As an initial comment, PIAC believes that the allowed return on debt should not be based on the current debt costs of each individual firm subject to a regulatory determination. This would effectively mean that the costs of debt were a simple pass-through and would not encourage networks to adopt efficient financing arrangements.

However, it is instructive to consider whether there are consistent developments in the management of debt by utilities, such as those listed in previous sections of this submission.

Of particular concern is the current regulatory practice to assume (from a methodology point of view) that all debt for the 5-year determination period is raised over a short period of time close to the determination itself.

This is highly problematic and is not supported by observation of private sector network reports.

Rather, as we have highlighted previously, the prudent debt financing approach of regulated entities consists of the acquisition of a portfolio of debt instruments with a range of maturity dates, and to hedge a proportion of the interest rate exposures by reference to the allowed regulated rate.

PIAC's view, therefore, is that the approach set out in the Guidelines should be focussed on the outcomes, that is, consistent with the allowed rate of return objective and, ultimately, the objective of servicing the long-term interests of consumers.

To the extent that a portfolio approach using historical averaging provides more stability in the cost of debt, while not exposing networks to unhedgeable risks, then this approach is to be preferred as consistent with the overall objectives.

---

53 Macdonald-Smith, above n 26.

# 5. Other issues

## 5.1 Appeals to the Tribunal

The recent rule changes and the AER's response to them do not directly address the role of the Tribunal. This has come under some criticism in the recent study by Yarrow et al as being too narrow, of failing to asses the overall outcomes of their orders and not sufficiently attending to the impacts of these rulings on the long-term interests of consumers.[54]

If the Tribunal's approach continues unchanged, it may pose a further threat to achieving the objectives of the regulatory reform even with the introduction of the allowed rate of return objective in the Rules as the principle outcome.

PIAC recommends that the Standing Council on Energy and Resources (SCER) progress consideration of the additional rule change proposals as recommended by Yarrow et al in sections 6.1 and 6.2 of their Final Report[55] and any relevant changes to the NEL and National Gas Law (NGL).[56]

For example, Yarrow et al conclude in section 6.1 that:

> For the avoidance of doubt, the NER and NGR should restate the requirements of the NEL and NGL that the primary regulator is to be guided by the NEO and NGO, and to take account of the revenue and pricing principles when making revenue determinations. [57]

***Recommendation 5***

*PIAC recommends that SCER affirm that the AER be guided by the NEO and NGO, and that it should take account of revenue and pricing principles when making revenue determinations.*

***Recommendation 6***

*PIAC recommends that SCER consider progressing the further rule change proposals advocated in the report by Yarrow, Egan and Tamblyn into the Limited Merits Review regime.*

# 6. Conclusion

Once again, PIAC welcomes the opportunity to provide comment to the AER on the development of the rate of Return Guideline as part of the Better Regulation program. PIAC similarly welcomes the highly consultative approach that the AER has chosen to adopt in developing the various guidelines under the Better Regulation program

54 Yarrow, et al, above n 23, 2.
55 Ibid, 59-70.
56 The NEL and the NGL set out the powers of the Tribunal, the basis for appeal to the Tribunal and matters the Tribunal should have regard to in coming to its decision on whether the AER has made an error of fact or was incorrect in the exercise of their discretion or was unreasonable in all the circumstances. See for instance NEL s 71.
57 Yarrow, et al, above n 23, 59.

PIAC's position is that under the old NER, the necessary focus on the long-term interest of consumers was lost in the detail and complex specifics of determining the WACC and rate of return. PIAC is hopeful that the current process represents an opportunity to refocus network regulation on the ultimate intent of the NEO and NGO.

However, PIAC has some concerns about the non-binding nature of the proposed Guidelines. PIAC acknowledges the significant resources that consumer advocates will expend engaging in the Better Regulation Program in an effort to produce outcomes that are in consumers' long-term interests. While PIAC welcomes the consultative approach taken by the AER, there is an urgent need to close off options for alternative approaches that are not based on meaningful consultation with consumers who ultimately bear the cost of this essential service. More information from regulators and rule makers on minimising this risk must be provided without delay.