Phone 1800 245 092
Web powerwater.com.au

Record No: D2018/404267
Container No: F2011/6726

Mr Warwick Anderson
General Manager, Network Finance and Reporting
Australian Energy Regulator
GPO Box 520
Melbourne VIC 3001

Via email: warwick.anderson@aer.gov.au

Dear Mr Anderson,

Submission on the Australian Energy Regulator's (AER's) draft 2018 rate of return guideline

Thank you for the opportunity to comment on the AER's draft rate of return guideline, published on 10 July 2018. We recognise the importance of ensuring that rate of return allowances are fair and reasonable.

The explanatory statement to the draft guideline responds to our proposed approach to setting the return on debt allowance for Power and Water Corporation, which was made as part of our initial regulatory proposal for the 2019-24 regulatory period. We are concerned that the statement and draft guideline do not fully engage with our proposal. Our letter focuses on these concerns.

We ask that the AER consider these concerns before finalising the 2018 rate of return guideline.

Our background

We own and operate the smallest electricity network in the country. We are transitioning from jurisdictional regulation to the national framework, which is a significant change for our business, our people and our customers. Economic regulation has recently transitioned from the Northern Territory's (NT's) Utilities Commission (UC) to the AER, and other functions are following suit over the coming 18 months.

As part of this transition, the AER must for the first time set a return on debt allowance for Power and Water to apply over the 2019-24 regulatory period. We proposed that this allowance should recognise that the effective return on debt allowance for the 2014-19 regulatory period – set through Ministerial Direction – was significantly below the on-the-day rate that was determined by the UC and at a level such that the resulting allowance over the full 2009-19 period aligned to a trailing average return on debt over that period. [1] Our position is that this means that we have already transitioned to a trailing average and so the trailing average method should be used to set the return on debt allowance for the 2019-24 regulatory period, without a transition.

1 See: PWC, 31 January 2018, *Return on debt transition*, Attachment 1.10 to Power and Water's initial regulatory proposal.

The AER – as stated in the explanatory statement – did not agree with this position.

Our concerns

Our key concern is that the AER has not fairly engaged with our return on debt proposal. This may be because the AER intends to do so as part of its forthcoming draft decision for Power and Water, expected by the end of September. However, given the importance of this issue to us, we pre-emptively raise our concerns now.

In short, our concerns are:

- **The AER refers to our proposal as an immediate transition, which is not accurate.**[2] Rather, we are proposing to start with the trailing average approach as there is no need to transition to it. The AER's will be first decision under the NT National Electricity Rules and, as noted above, our current allowance is in effect a trailing average already.

  This may sound like a simple definitional point. But to us it is more than that because the AER's characterisation risks the AER and its staff inferring that we are reiterating arguments made previously by other networks about 'immediate transitions' or 'hybrid transitions' over the 'guideline transition'. We are not making those same arguments. We are simply saying that there is no need to transition us at all – our current tariffs already reflect a trailing average return on debt.

  The explanatory statement, for instance, explains that a 10-year transition period was adopted to "allow a progressive change between two different approaches of setting the allowed return on debt" or to "switch between regimes".[3] Our position is that there can logically be no such change as our *current* effective allowance reflects a trailing average as does the proposed end point of the transition. It would be illogical, therefore, to introduce a transition.

  It appears that the AER's reasoning misses this salient point.

- **The AER asserts that there would likely be a windfall gain or loss under our proposal, but not under a 10-year transition, without any analysis of our circumstances to prove it.**[4] The AER relies on the NPV=0 principle to support this assertion and maintains that the 10-year transition is revenue neutral. However, this analysis is flawed because:

  - The NPV=0 principle can only really hold at the start of a transition as in all subsequent years the return on debt allowance will be set using historical return on debt observations – and so fail that principle, which the AER recognises in relation to the trailing average approach[5]

---

2 AER, 10 July 2018, *Draft 2018 rate of return guideline, Explanatory statement*, section 9.2. For instance, the heading refers to 'NT Power & Water's proposal for immediate transition'.

3 Ibid, pp. 330 and 331.

4 Ibid, section 9.2.

5 Ibid, p. 331.

  - Revenue neutrality depends on what revenue is being measured against – the explanatory statement implies that this is against an assumption that the return on debt were set based on the on-the-day approach, but it is not obvious why this is so and it appears to us inconsistent with the actual circumstances facing Power and Water.

  We consider it inappropriate for the AER to rely on these arguments in the selective way that it has. Moreover, if – as we note above – our current tariffs already effectively reflect a trailing average approach, then for the reasons explained by the AER switching from that approach to the on-the-day approach at the start of the 10-year transition (back to the trailing average approach) without first transitioning to that starting point would not be revenue neutral. Rather, it would lead to a windfall loss to Power and Water.

  For these reasons, we consider that a 10 year transition to the trailing average approach for Power and Water is not consistent with the National Energy Objective (NEO).

- **Finally, the AER also states that the 10 year transition should apply to us because our current return on debt allowance is not set via an annual updating return on debt, without explaining why this is relevant.** Under a revenue cap – such as applies to Power and Water – tariffs over a regulatory period are set so that a regulated network can recover its allowed revenues. The return on debt allowance is reflected in building block revenues that are smoothed over the regulatory period, even if the return on debt observation for a given year is updated within that period rather than set ex ante or trued up for ex post.

  Our proposal makes clear why we consider that the ex post return on debt allowance that has been reflected in our tariffs over the 2009-19 period is effectively a 10 year trailing average. It is not obvious to us why it is relevant whether the return on debt allowance was updated each year during that period or not.

  In our case, the most appropriate assessment is whether at the end of that period our effective allowance more accurately reflects a trailing average rather than an on-the-day allowance. Our position is that it does.

Our proposed solution

Importantly, our concerns raised above do not mean that the draft 2018 rate of return guideline needs to be changed to address these. Rather, it simply means that when applying it the AER should interpret the first year of the transition in clause 8(c) as being the 2009-10 year, which – as we explained in our initial regulatory proposal – is the first year of the effective trailing average that is reflected in our current tariffs.

We would welcome the opportunity to discuss this proposed solution – and our concerns above – further with AER staff; and will actively engage with the AER in response to its forthcoming draft decision.

If you have any questions regarding our feedback in this submission, please do not hesitate to contact Jodi Triggs, Senior Executive Manager Network Regulation and Commercial at Jodi.Triggs@powerwater.com.au or on 08 8985 8456.

Yours sincerely

Michael Thomson
Chief Executive
11 September 2018