Balancing risk and reward:

submission to the AER's Consultation Paper:
Rate of return guideline

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Bev Hughson, Darach Energy Consulting Services

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

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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;
- the Physical Disability Council NSW; and
- Affiliated Residential Park Residents Association.

Rate of return guideline

The Public Interest Advocacy Centre (PIAC) welcomes the opportunity to respond to the second paper by the Australian Energy Regulator (AER) on the Rate of return guideline (the Guideline).

PIAC acknowledges the importance of the Guideline and expresses its appreciation to the AER for their extensive investigation of this key issue, including the publication of the *Rate of Return Guideline; Consultation Paper* (Consultation Paper).[1]

PIAC also appreciates the additional analysis undertaken by the Regulatory Development Branch (RDB) of the Australian Competition and Consumer Commission (ACCC) presented in its report, *Estimating the Cost of Debt, a Possible Way Forward.*[2] This has provided further insight into the complex conceptual and practical issues involved in the assessment of the cost of debt and transitioning to a new framework.

Importantly, in PIAC's view, the extensive consultation and analytic process being undertaken by the AER during the development of the Guideline will address the key criticisms of the AER's decisions by the Australian Competition Tribunal (Tribunal). Over the course of numerous appeals, the Tribunal has clearly stated that if the AER is to reject a Network Service Provider's (NSP) proposal, then its arguments for doing so must be rigorous, transparent and demonstrably reasonable under the circumstances.[3]

PIAC expects that this current process will address the issues raised by the Tribunal and, therefore, bring an end to regulation by litigation. PIAC would also hope that by reducing litigation, the Guideline process will encourage the AER and the NSPs to work co-operatively with consumers and to focus on the core business of delivering efficient network services to the Australian community.

It is PIAC's understanding that the Guideline will provide a framework for regulatory decision making across all sectors of the industry – that is, electricity and gas transmission and distribution networks service providers – in line with the recommendations of the Australian Energy Market Commission (AEMC). While there are clearly differences between the sectors, having a common framework will be of assistance to investors and consumers alike.

What does PIAC expect from this process?

The regulated electricity and gas NSPs play a fundamental role in the Australian economy and in the welfare of Australia's businesses and people. The NSPs also enjoy a privileged position as providers of monopoly services, not subject to the same degree of domestic and international

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1. Australian Energy Regulator, *Consultation paper, Rate of return guidelines*, 2013.
2. Australian Competition and Consumer Commission, Regulatory Development Branch, *Estimating the Cost of Debt, a Possible Way Forward*, 2013.
3. See, for example, Australian Competition Tribunal, *Application by United Energy Distribution Pty Limited* [2012] ACompT 1 (6 January 2012) at 461: "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 …Its estimating practices, data sources and reference periods must be well articulated, consistent and communicated to the parties…"

competitive pressure as their customers and protected by a strong and largely consistent regulatory framework.

The National Energy Objective (NEO) and National Gas Objective (NGO) sit at the heart of this regulatory framework, defining the overall regulatory objectives of providing efficient network services in the long-term interests of consumers.

From PIAC's perspective, the long-term interests of consumers are, in turn, best served by a regulatory regime that finds a balance between the legitimate interests of investors in receiving a fair return for risk and the provision of network services of the appropriate quality, safety and reliability at a fair price to consumers.

The regulatory framework expresses this balancing requirement through the hierarchy of:

- overarching regulatory objectives (NEO and NGO) to act in the long term interests of consumers;
- National Electricity Law (NEL) and National Gas Law (NGL), including a statement of regulatory revenue and pricing principles (RPP);[4] and
- National Electricity Rules (NER) and the National Gas Rules (NGR), including the allowed rate of return objective (ARRO).

In past regulatory decisions, the RPP appears to have had some degree of primacy; perhaps reflecting a real concern with ensuring there was sufficient investment in the energy infrastructure. The November 2012 rule changes have been driven in part by a desire to restore the NEO and the NGO to a central role in regulatory decision making, while continuing to acknowledge the importance of efficient investment, as expressed in the new ARRO:

> The allowed rate of return objective is that the rate of return for a [Distribution] Network Service Provider 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 Distribution Network Service Provider.[5]

PIAC is therefore a strong supporter of the Better Regulation program and commends the AER, the AEMC and others in recognising the urgent need to establish a better balance between the interests of investors and consumers.

PIAC is seeking an appropriate balance of these interests through the Rate of Return Guideline process. PIAC's views on how this can be best achieved are set out in this submission.

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4 NEL Schedule Part 1, section 7A, cl (2) - (7), which requires (inter alia) the regulator to provide a regulated network service provider with at least the efficient costs incurred in providing direct control network services and complying with regulatory obligations.

5 NER, cl 6.5.2 (c) and equivalent sections in NER chapter 6A and the NGR.

However, PIAC would also like to highlight that the rate of return assessment inevitably involves the exercise of regulatory discretion and that this discretion must be exercised in the context of the evolving requirements of both NSPs and consumers. Ensuring that there are clear principles to guide the AER is therefore critical to the success of the program.

Recognising the need for a balance between investors' and consumers' interests *over time* is one such principle.

This, in turn, requires that the AER's approach to the calculation of the cost of capital results in an *unbiased estimate of the cost of capital over time*.

Under this primary principle, there will be periods when consumers will be better off relative to the 'true' cost of capital and periods when the networks will be better off. However, the AER's approach should ensure that there is equity in the protection of investor and consumer interests over time.

PIAC, for instance, is concerned about the possibility that the Guideline will set out multiple options that allow NSPs to 'cherry pick' their preferred approach from one regulatory period to another, or between like businesses. These outcomes may distort the important principle of balancing interests of investors and consumers over time.

A second principle follows from the primary principle of balanced outcomes. The fluctuations between the allowed and actual cost of capital should cancel out over time (which will happen if there is unbiased estimate of the cost of capital), and also the AER's approach should ensure that the fluctuations at any point in time do not result in undue financial stress to either networks or consumers.

From a network perspective this means that there is adequate cash flow to fund their *efficient* operations and provide an *appropriate risk adjusted* return to investors. For consumers, it means that they are not exposed to unexpected price increases in their energy bills or, more generally, network prices that reflect inefficient investment in the network.

Important to achieving these outcomes is the use of well-accepted models with sound theoretical and empirical support, fit for purpose and with internal consistency, along with reliable and well-defined data sets, and implemented appropriately for the circumstances. The AER has identified a similar set of criteria in the Consultation Paper and PIAC strongly supports this approach for the reasons outlined above.[6]

Summary of PIAC's key recommendations

As discussed above, PIAC's primary concern is for the regulatory reform process to achieve a better balance between the interests of investors and consumers over time.

The approach adopted by the AER to the allowed rate of return must adequately reward efficient levels of investment in the networks and provide incentives for ongoing improvements by the

6 AER, as above n 1, 19-21.

NSPs. It must also ensure that consumers receive network services that are fairly priced, and of the appropriate quality, safety and reliability.

However, the AER's obligation to ensure that NSPs receive a rate of return to recover their efficient cost is not based on the performance of individual NSPs. Rather, it is based on the concept of the *efficient financing of an efficient benchmark firm* with similar risks as expressed in the rate of return objective.

On the basis of the evidence provided to date, and understood in the context of the regulatory objectives outlined above, PIAC's overall position on the key questions raised in the Consultation Paper can be summarised as follows:

1. Move from 'on the day' approach to a 'portfolio' approach (i.e. using 'historical averaging') to set expected future cost of debt as this will provide a more stable regulatory outcome, and is in the interests of consumers and investors; the details of the historical averaging approach in terms of the length of the period and the like can be best determined by further empirical investigation of volatility and risk.

2. Recognising the limits of all the relevant models and data outputs, avoid added complexity for doubtful levels of additional accuracy. For example, there should be no annual updating of debt or weighting applied, *unless* it can be empirically established that they add a level of accuracy that significantly offsets the complexity and lack of certainty they create.

3. For the cost of equity, select a principal model based on the criteria set out in Chapter 3 of the Consultation Paper and use other models/data as a cross check— given each alternative has its own limitations and there is no agreement amongst financial experts as to which alternative is the better.

4. For the cost of debt, do not adopt the so-called 'menu' approach, as this undermines the objectives of balancing investor and consumer interests over time and increases the opportunity for gaming.

5. Given the limitations of all approaches (as per points 2–4 above), PIAC has a general preference for relying on existing established models and parameters as the primary tools unless there are substantive reasons for change (such as the proposed move from 'on the day' to historical averaging for the cost of debt).

6. Minimise the number of efficient benchmark entities; separate benchmarks should only be used when there is clear empirical data that supports the existence of significant relationships between the NSPs' circumstances and their approach to raising capital and associated cost of capital.

7. There are various approaches suggested to address the transition from 'on the day' to historical averaging for the cost of debt; these need to be critically examined to assess if the benefits to NSPs and consumers of a transitional approach significantly outweigh the complications of various approaches to transitioning.

8. Consistency in regulatory approach is an important objective and, therefore, while the AER now has the flexibility under the Rules to adapt its approach when circumstances change, this should only be done when there is unambiguous evidence that the changes represent a long-term shift, not a temporary aberration.

A more detailed assessment of PIAC's expectations from the process follows. Responses to specific questions are provided in Section 2.

Rate of return: a new approach

Recommendation

The new approach to the rate of return should resist the pressure to create multiple benchmarks for the purposes of assessing efficient financing for an efficient benchmark NSP for a range of different circumstances.

To make each entity its own benchmark undermines the basic principle and purpose of benchmarking, and may reward inefficient corporate financing and corporate structures.

For example, there are a number of publically listed NSPs that have had periods of very high volatility in their return on equity, share price, dividend yield, credit rating and other measures. If they are used as their own benchmark, then the regulator might, for instance, assign a high equity beta for that business or sector of the industry.

Yet, an examination of their financial history indicates the volatility in earnings and/or a high cost of equity and debt, is more a reflection of management decisions and risk taking, and is not representative of efficient financing.[7]

Consumers should not have to pay for poor financial, risk or operational management through an increased regulatory allowance for the cost of capital. It is shareholders who must fund this and who, in turn, hold management accountable.

Multiple benchmarks simply adds to the risk that the underlying causes of different capital costs are misinterpreted and that NSPs have limited incentive to improve.

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7 For example, the analysis presented by the AER, *Return on equity: Note on dividend growth model estimates (illustrative example),* 4 June 2013, indicates a very high dividend yield for Envestra Ltd (and others) in the 2008-09 period, an outcome that has led to suggestions that an equity beta of over 1 should be assigned to the gas NSPs because (presumably) of their high non-systemic risk. However, an alternative explanation is that this outcome reflects specific risks arising from how the businesses have managed their financial position. For example, in August 2008, Standard & Poor issued a press release, *Envestra Outlook Revised to Negative On Aggressive Financing; Group Ratings Affirmed*. The press release referred (inter alia) to Envestra group's 'unchanged aggressive approach of using debt to fund its growth while maintaining shareholder returns (dividends)'. Importantly, Envestra has since adopted a different capital management strategy and has now been upgraded to BBB and is funding growth largely out of cash reserves; its dividend yield is now close to the average S&P 200.

Recommendation

The new approach should be based on a sound understanding of the relative risks facing a regulated monopoly business (within the context of the NER, NGR etc.) and of how these risks can be best managed.

PIAC has consistently highlighted the importance of a comparative assessment of risk and an understanding of the way risk can be managed using, for instance, financial tools, and how any residual risk (and any reward) should be shared with consumers.

PIAC is therefore pleased to see the AER undertake a further consultancy on this issue and hopes to see the results of this study effectively incorporated into all aspects of the rate of return guideline.

Recommendation

The new approach should provide incentives for continuous improvements in capital investment and capital management.

With respect to the rate of return, this means that the level of the rate of return is such that, given the right management and business structures, networks can 'beat the target', and retain the benefit.

However, the rate of return should also be sufficiently 'tight' that it does not allow for complacency by management. Management becomes accountable when shareholder returns are not given, but are earned.

Determining the rate of return on the basis of the benchmark efficient NSP provides an incentive to beat the benchmark as discussed above.

In addition, the NSPs' customers, particularly their business customers, are operating in unregulated competitive markets, and for them, capital is a scarce commodity and capital management within budgets is a priority for the company's board and management team.

All customers have a reasonable expectation that the AER's allowed rate of return (along with capital expenditure incentives) should impose a similar capital expenditure discipline on the NSP's management team.

In targeting this outcome it is important for the AER also to recognise that the benchmark process, built around the concept of a stand-alone network business being financed by traditional Australian funding sources, is a long way from the reality of most network businesses.

In practice, the NSPs receive (sometimes considerable) benefit from State Government Treasury funding (NSW, Tasmania and Queensland NSPs) or parent company financial 'muscle' (Victorian and SA NSPs). They are also increasingly able to access large tranches of overseas funding (in parcels of at least $150 million) with a variety of tenors and at relatively low cost.

PIAC accepts that the rate of return should be assessed against the conceptual benchmark outlined by the AER. However, when making judgements with respect to rate of return parameters, PIAC requests the AER to bear in mind that the benchmark stand-alone entity is now a very conservative concept and in practice, NSPs have considerable flexibility and are able to access multiple sources of funding in Australia and overseas.

Recommendation

The new approach should recognise the expectations of investors when they invest in regulated, long-term asset, low-risk businesses.

Monopoly businesses are widely recognised as having relatively low levels of risk (assuming they are well managed and appropriately structured) compared to businesses operating in competitive markets or more highly exposed to economic cycles or technological obsolescence.

Debt and equity investors in regulated networks are, in general, looking to balance their portfolio with investment in stable, long-term, assets with good cash flows and sound management. In seeking funding for their business, networks should also seek out such investors – they are not ‘get rich quick’ businesses, and should not attempt to compete in that market for short-term investor funds.

The expectations of long-term investors, and the value they can add to infrastructure companies such as the NSPs, are well illustrated in a recent presentation by the President and CEO of the Canadian Pension Plan Investment Board (CPPIB) that has over $155 billion in its investment portfolio. The CPPIB sees infrastructure investment as an important part of its objective to achieve returns without undue risk over the longer term. For example, the CPPIB’s President says:[8]

> Long duration infrastructure assets are highly attractive investments for us because we manage a portfolio that spans multiple generations;
>
> Such investors (long term investors) are less focussed on interim changes in asset prices and instead on long-term income growth and/or long-term capital appreciation; and
>
> …long-term investors can play an important role in helping stabilise markets in times of stress they can act as liquidity providers and counter-cyclical investors in such times to counter-balance the [short-term] actions of other investors.

PIAC notes here that even the smaller NSPs are now tapping into the type of investor interested in lower returns for lower risk over the longer term, by accessing longer-term lower-interest bonds (for example).

[8] David Denison, Canadian Pension Plan Investment Board (CPPIB), *CPPIB in Australia: In it for the long term*, speech to the Canadian-Australian Chamber of Commerce, Sydney, 2 February 2012, 8, 12 & 13. Some 50 per cent of the CPPIB Asia-Pacific investments are in Australia.

Recommendation

The new approach should provide greater stability and consistency in pricing network services.

The new approach should proactively seek to avoid the disruptive cycles of under and over-investment in networks, and the corollary of price volatility for consumers.

All consumers, including small and large businesses and residential consumers, have been subject to significant financial stress as a result of the extreme increases in network pricing, particularly in some states, over the last five years.

Volatility might be expected in highly competitive markets such as the wholesale gas and electricity supply markets, but in these markets competitive forces and arbitrage drive prices to a more stable equilibrium over time.

It is far more difficult to understand why prices for a non-competitive and relatively predictable service such as network services should be subject to such extremes both within and between regulatory periods.

The new approach therefore should focus on achieving a more stable and predictable pricing and investment outcome.

Given the information provided to date, PIAC is of the view that the *historical averaging approach with no annual updating of the rate of return achieves* the best balance between (a) stability of investment and pricing over time and (b) the long-term interests of consumers for these low risk, long-life asset businesses.

Similarly, stability, transparency and equity over time is best addressed by ensuring that there is:

- a limited number of benchmarks, based on empirical evidence that there are materially different types and/or degrees of risk which impact directly on the cost of capital; and
- an approach to assessing both the cost of debt and equity that relies on a single primary approach for the each of these measures; that is, the Guideline sets out a single preferred approach to the cost of debt and, similarly, a single primary model for the cost of equity.

Other models and data sources can then be used for reasonableness checking, but only under clearly defined conditions.

Recommendation

When considering transitional arrangements, the AER should be cognisant of the fact that the current regulatory approach has benefited NSPs at a cost to consumers. It is reasonable that consumers do not bear additional costs associated with transition to a more balanced approach.

PIAC would not support transitional arrangements that provide compensation to NSPs for any loss of earnings brought about by regulatory reforms aimed at facilitating more efficient network pricing. Such compensation would be counter to the purpose of the reforms and erode the good faith shown by consumers in forgoing the potential for future gains in order to reduce complexity, maximise transparency and capitalise on common ground between stakeholders.

Recommendation

The new approach should build in the consultative and co-operative processes that have emerged during the Guideline development process.

PIAC considers that there is still some work to be done to finalise the rate of return guideline. It considers that the processes of consultation and co-operation need to continue through to the final guideline and beyond, in its implementation.

In addition, it is clear from the work to date, that there is no single correct answer to the assessment of the rate of return and that the market place for funds continues to evolve, as do the requirements of networks and consumers.

For instance, it is not yet clear if the global financial crisis (GFC) has lead to some fundamental changes in the financial markets or if it is a (big) 'blip' and the process of 'reversion to the mean' will continue to apply. The latter would appear to be the more likely outcome, and PIAC believes that the AER should respond on that basis. However, it should be monitored to see if there are long-termer impacts on the behaviour of investors and/or consumers.

For this reason, PIAC agrees that the rate of return guideline should be reviewed in three years. PIAC also considers that a process of continuous engagement with consumers on the rate of return and related issues will benefit that review process and assist in developing the general capacity of consumers to participate in the wider regulatory processes.

Comments on the specific questions asked in the Consultation Report follow.

Response to questions in the Consultation Report

Q 3.1: Do stakeholders agree with our proposition that we should continue to determine the rate of return by ultimately selecting point estimates (possibly from within ranges) of the return on equity, the return on debt, and gearing?

This question again highlights the need to balance transparency and certainty on the one hand with, on the other hand, providing room for regulatory discretion and flexibility to respond to different circumstances. The question also reflects a recognition that there are limitations with all of the various models and data used in the calculation of the rate of return.

For example, as noted in the Consultation Paper, the Independent Pricing and Regulatory Tribunal of NSW (IPART) calculates a range of values for the cost of debt, cost of equity and the overall weighted average cost of capital (WACC). Given the range of feasible WACC outcomes, IPART then exercises its discretion, bearing in mind the limitations of the various modelling approaches.

This has enabled IPART to respond to the very particular economic and financial market conditions that have followed on from the GFC (for example), by choosing a final WACC outcome at the upper end of the range. As stated by IPART in their review of the regulatory WACC: [9]

> It [the current WACC methodology] has been subject to considerable stress during the period since the GFC and we have been concerned that the midpoint estimate has understated the cost of capital for the benchmark firm. However, we have been able to use our discretion to set the WACC at the top end of the range, having strong regard to the long-term averages for all parameters.

However, while it may be useful in principle for the AER to have the discretion to choose a final WACC number within a range of possible WACC outcomes, the regulatory regime is somewhat different in NSW. For example, IPART is not subject to the same Limited Merits Review appeal process as the AER. Therefore IPART does not face the same risk of judicial intervention in its decisions as the AER has when it has used its discretion to modify the modelled outputs (notwithstanding the known limitations of the models).[10]

There is also a relationship between the general approach adopted by the AER and the use of a point or range estimate. For example, if the AER were to adopt the approach of selecting a primary model for cost of debt and for cost of equity (with other models/data used for checking the reasonableness of the primary model's output) then this is more likely to generate a single point estimate.

If, on the other hand, the AER were to adopt multiple approaches with reasonably equal weighting then it would be more consistent to adopt a range estimate. The regulator can then apply its discretion to select a point estimate WACC within this range.

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9 Independent Pricing and Regulatory Tribunal, *Review of method for determining the WACC, Dealing with uncertainty and changing market conditions*: Discussion Paper, 2012, 77.

10 See for instance, the Australian Competition Tribunal, as above, n 3.

Ultimately, if a range approach is selected by the AER in the Guideline, then it is also essential that there is clarity around the principles and process of selecting a point within that range.

For example, if it is decided to use both a historical and prospective market risk premium (MRP) calculation, which will produce a range of (say) 5.5% to 8% for the MRP, then the AER should explain in the Guideline what principles it would use to select within the range. For instance, one principle could be the degree of volatility in equity markets, with higher volatility being associated with using a point estimate from the higher end of the range (similar to the IPART approach).

The application of some (pre-set) principles is also important in the situation where the range is not derived from statistical probability or scenario analysis, but rather, represents the output of different models. As highlighted in the 2009 AER review of the WACC parameters, both the lower and the upper bounds of the range are 'equally likely' to be a 'true' point estimate. [11]

Notwithstanding these comments, PIAC's position remains that transparency and confidence in the regulatory process requires a relatively deterministic process, albeit one that can be more flexible in the face of defined exogenous conditions that are outside the normal range of variation in economic parameters.[12] The suggested approach would be as follows:

1. use of a single primary model for cost of equity and data set (e.g. a relevant Bloomberg yield series) for the assessment of the cost of debt;

2. use of a gearing ratio and equity beta (derived using data external to the CAPM) that are relevant to the benchmark entity and are established during the Guideline process.

3. the generation through the models and data of a point estimate for each of the cost of equity and cost of debt;

4. the mechanistic generation of a point estimate for WACC, based on the gearing ratio derived in step 2 ;

5. assessment of the reasonableness of the aggregate WACC against other models/data on WACC prevailing in the broader financial market at the time of the determination;

6. If there is a significant discrepancy identified in Step 5,
    - Reassess the input parameters into the cost of equity and cost of debt model, along with alternative modelling approaches and empirical data;
    - Undertake scenario testing to ensure that the cash flows of the businesses (in general) are not so impeded that they threaten the status of other parameters (BBB+; 60 per cent gearing, 0.8 beta etc.)

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11 AER, *Electricity transmission and distribution network service providers, Review of the weighted average cost of capital (WACC) parameters,* Final Decision, 2009, 243.

12 The emphasis here is on exogenous events outside of the normal range of variation. It should certainly not be 'flexible' in response to the particular conditions of an individual company. See for instance, the discussion in n 7, with respect to Envestra.

This approach is focussed on the reasonableness of the WACC as a whole, rather than adopting multiple checks (in the first instance) on the inputs to the WACC calculation in Step 6.

It will, therefore, also provide some level of certainty for NSPs and consumers under most circumstances, while ensuring that NSPs are financially protected and providing the AER with some flexibility to respond to more extreme economic circumstances.

Interestingly, the Standing Council of Energy and Resources (SCER) has just released its response to the Limited Merits Review Regime. The SCER's recommendations will place an onus on both the regulator and the Tribunal to consider the '*overall decision'* and whether it is '*preferable*' in terms of serving the long-term interests of consumers. This is closely aligned with the process outlined by PIAC above.[13]

Q3.2: What is the appropriate term for the return on equity? Do stakeholders support Lally's recommendation based on the present value principle that the appropriate term should be consistent with the regulatory period?

Q3.3: What is the appropriate term for the return on debt? Do stakeholders agree with the view that a specific terms is not required, if we apply an approach that is similar to the ERA's 'bond-yield approach? Is there a case for the same terms for the return on equity and return on debt?

There appears to be three broad approaches to the question of the appropriate term for assessing the return on equity and return on debt. They are:

- the term is based on the regulatory period;
- the term is based on the life of the assets (as far as practical); and
- the term should not be specified.

However, there is an additional question that must be considered in advance of considering the benefits and risks of each of the three options above:

- should the same term apply to both the equity and debt calculations?

In principle, it is not clear that the equity and debt terms should be the same. They are two very different sources of funding with their own drivers, risks and benefits. That is, providers of equity and of debt may have very different motivations, as will the NSP when seeking either equity or debt funding.

In addition, the regulatory regime imposes somewhat different requirements on the regulator in assessing the cost of equity and the cost of debt. For example, when assessing the cost of equity

13 See Standing Council of Energy and Resources, *Limited Merits Review Regime,* Bulletin six, 6 June 2013, 2. Amendments to the NEL and NGL will be made to give effect to the policy intent that consideration of the long-term interests of consumers is a requirement of both the initial economic regulatory process and any subsequent reviews.

the Rules require that '*regard must be had to the prevailing conditions for equity funds*', while for the cost of debt the emphasis is on reflecting the actual debt portfolio (of an efficient benchmark firm). [14]

On the other hand, if different terms are used for the cost of debt and the cost of equity, then the question of assessing an overall cost of capital on the basis of a weighted average of two measures that tap into market expectations for two different future periods with different risks, must also be considered.[15]

PIAC notes in this context that the AER has elsewhere expressed a desire to drive longer term planning by the networks, that is, to encourage an approach to investment in the networks that extends beyond the 5-year regulatory period.

PIAC would support the adoption of a longer term planning horizon for the AER and the NSPs as this would be more consistent with the long-term interests of both consumers and investors. A longer term, such as 10 years, also appears to be more aligned with the long tenor of most of the NSP's debt portfolios.[16]

However, there is also merit in applying a 5-year debt term that is aligned with the regulatory period as this minimises the risk of significant spread emerging (in either direction) between the actual and the allowed rate of return.

This may be particularly important if the approach adopted is of a constant cost of debt allowance for the 5-year regulatory period. If, on the other hand, a rolling average is used over the period with annual updates, there may be less of a mis-match between a 10-year debt term and the actual cost of debt. This can be tested empirically by the AER.

In addition, there can be a significant spread between the costs of 5-year and 10-year debt, although the amount is subject to controversy. The AER in their 2009 final report indicated that the 10-year term provided 'over-compensation' on the cost of debt of 18 basis points on average. On the other hand, a 5-year term assumption would tend to under-compensate the NSP.[17]

Offsetting the 'over-compensation', however, is the fact that the 10-year term was seen to reduce the risks and costs of re-financing,[18] and providing greater flexibility in the NSPs debt portfolio.

Given that there are reasons for choosing (and not choosing) either debt term (5-year or 10-year) perhaps the issue may come down to the practicalities of each approach. For example; is it easier to establish a reliable data set for the equity and debt models if a 5-year terms are used (as opposed to the current 10-year term); are there more or less transitional issues and costs?

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14 NER, cl. 6.5.2 (g) and cl. 6.5.2 (h) – (l), respectively.

15 For instance, the longer the term, the higher the premium in the cost of debt because of the increased uncertainty.

16 A comprehensive discussion of ta survey of the weighted average cost of debt for relevant entities is set out in AER, 2009, as above, n 11, 140 – 169. This discussion remains relevant.

17 AER 2009, as above, n 11, 168.

18 Ibid, 167.

Q3.4: For parameter estimates, should we adopt point estimates, ranges, or point estimates from within a range?

As per the previous discussion (Q 3.1), providing a range for the parameters provides the AER with more flexibility to exercise its regulatory discretion.

The 6-step approach suggested by PIAC in response to Q3.1, means that where the AER finds the overall WACC calculated from point estimates of the cost of debt, cost of equity and the gearing ratio is not (largely) consistent with other evidence, then the AER should look back to the parameters and model specifications.

Having an initial range (with supporting material) will facilitate this process while allowing the AER to retain the coherence of the decision making process.

PIAC therefore suggests the AER adopt point estimates from within a range for each relevant parameter, where this range is established through transparent and repeatable processes.

Q3.5: At what stage (during a determination or the guidelines process) should point estimates or ranges of the return on equity, return on debt and parameter estimates be established?

The Guideline should set out the principles, the assessment criteria, the primary models and assumptions where it is appropriate to fix these as a point estimate to apply across multiple determinations. This may include key features of the 'benchmark entity' such as the tax rate, gamma (imputation credit allowance), and gearing ratio. An equity beta estimate for each major sector (e.g. gas, electricity) could also be set as a point estimate.

The assumption here of course is that the AEMC's requirements for consultation and consideration of multiple options have been adequately addressed in the Guideline development process.

The point estimates for the cost of debt and cost of equity are then calculated and updated in the determination process.

Q4.1: Set out the risk factors that you consider should be compensated through the rate of return. How can we assess whether different companies are exposed to materially different degrees of these risks?

The assessment of risk is clearly an essential part of the rate of return determination; it underpins the expectations of both equity and debt providers with respect to the required rate of return.

It is also fundamental to consumers. Consumers too are exposed to risk on the 'other side of the coin' and a much-neglected aspect of the discussion about the risks faced by NSPs is the comparative ability of NSPs (with capital values in excess of $1billion) to manage risk in a way a small business customer or consumers generally cannot.

There is a strong argument to be put by consumers that in the past few years, consumers have been paying premiums in their energy prices for deemed risks which do not in fact exist, or which can be relatively easily mitigated by the NSP through efficient financial, capital and operational management.

In particular, the risks facing a NSP must be considered in the context of all the other factors in the regulatory regime, and more broadly, that can influence investors and/or serve to mitigate risk. These factors include (but are not limited to):

- the relative risk of the regulated network industry; that is the risk *relative* to other investment or lending opportunities (not the relative risk of the individual company which should be borne by management and shareholders, not consumers);

- a lower price elasticity; NSPs provide an essential service and are relatively unaffected by downturns in the economy, although they may be affected by structural changes, such as the closure of some energy intensive industries;

- the maturity of the energy market; the energy market is characterised by long-life assets and limited exposure to technological obsolescence;

- the specific features of the NSPs' regulatory regime, such as:
  - re-openers, pass throughs, contingent events;
  - the protection of the revenue stream (particularly under revenue control mechanisms) and 'largely predictable cash flows';[19]
  - indexation of the RAB, providing an in-built hedge as protection against inflation;
  - the effective absence of the threat of write-down or impairment of assets even when demand for services declines (relative to the forecasts that underpinned the revenue path);
  - the potential 'rewards' and 'penalties' provided under the regulatory incentive regime;
  - credit management under the access arrangements; for example, networks are largely protected from default by end-use customers as this is borne by the retailer and retailers also have to provide their own substantial bank guarantees (or equivalent credit support);
  - tariff cost reflectivity and controls; and
  - incentive based regulation rather than cost of service regulation, with greater opportunities for NSPs to define their future.

- the availability and the (relative) cost to the NSP of risk management tools, including insurance and hedging arrangements;

- the absence of competition (and a guaranteed customer base) for the provision of the regulated services;

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19 See for instance, Envestra Ltd website, Investor section, *Reasons to invest in Envestra,* 'Cashflows are highly predictable and grow in line with customer connections and annual tariff increases, thereby supporting sustainable dividends to shareholders over the long-term,' at <www.envestra.com.au/investor-centre/share-performance/reasons-to-invest/>.

- the sharing of risk between the NSP and consumers, including the assessment of who is best placed to manage risk, for example:
    - if demand is less than forecast, who should bear the risk (currently, consumers bear the risk in most jurisdictions); and
    - NSPs can (and do) diversify their debt portfolio, re-negotiate bank facilities, and hedge interest rates.

Q4.2: Do different return on equity models account for systematic risk differently, or do they also account for non-systematic risk? If the latter, is it appropriate for the AER to set allowances that remunerate risks that could be diversified away from?

PIAC understands that the current CAPM model used by the AER for the cost of equity (based on the Sharpe-Linter CAPM), accounts only for systematic non-diversified risk, with the equity beta calculated exogenously by the AER.

The equity beta applied to the market risk premium reflects the extent to which the movements in the regulated network industry's equity returns are correlated with the volatility in equity returns of the total market. It is not, therefore, a measure of non-systematic risk per se.

From PIAC's perspective it is not appropriate to introduce any additional sources of estimation and remuneration for the NSP such as the non-systematic risks assessed on the performance of an individual NSP. Management of this type of additional and specific risk should be the responsibility of the company board and executive accountable to their shareholders. Consumers should not share this risk through higher prices.

An important point, albeit somewhat tangential to this question, is the effect of 'current market circumstances' on the equity beta. PIAC's response to the Issues Paper[20] highlighted commentary from the chief financial reporter in *The Australian Financial Review*, which suggested that in difficult economic times, regulated utilities are attractive investments because of their low risk and resilient cash flows.[21]

This suggests an inverse correlation between the returns to the regulated utilities and the equity returns in the market in general in difficult economic periods. Should the approach to the cost of equity take this into account, for instance, by using a 'range' of beta values from a low beta in GFC type conditions when investors look to invest in regulated stable businesses, up to a maximum of 0.8 in more normal economic periods?

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20 Public Interest Advocacy Centre, *Better Returns for Consumers:* Submission to the AER's Rate of Return Guidelines Issues Paper, 2013, 25, at <www.piac.asn.au>.

21 Angela Macdonald-Smith, 'Power companies deliver solid returns', *The Australian Financial Review,* Print Edition, 12 September 2012. The article also cites another report by RBC Capital Markets which highlights that the utilities sector was a 'star performer' in the 2012 financial year. As market confidence waned, the benchmark utilities index grew 11 per cent against an 11 per cent dip in the broader ASX 200 Index.

Q 4.3: Do you agree that the AER should seek to utilise the smallest number of benchmarks that capture materially different degrees of risk? How do we utilise different benchmarks while retaining the objectives of incentive based regulation?

PIAC strongly supports the AER's proposal to use the smallest number of benchmarks that capture materially different degrees of risk. An approach that sets common targets of performance is fundamental to driving efficiency improvements across the networks.

PIAC notes the suggestion by some stakeholders at the various rate of return workshops that the new rate of return objective means that the benchmark efficient entity must reflect the specific circumstances of each service provider at each particular determination.

Such an interpretation is misguided and should be rejected by the AER. It makes nonsense of the both the theory and practice of benchmarking if every firm is its own benchmark, whether the benchmark relates to efficient financing costs or to operational costs and service delivery performance.

Moreover, the proposal as presented in the various industry submissions appears to lack internal consistency.

For example, the same proposals that favour assessment of the WACC on the basis of the 'specific' circumstances of each service provider also seek to include in their definition of the benchmark firm the concept of the stand-alone firm 'without parental ownership'.[22]

The ideal of a 'stand-alone firm' is clearly an abstraction from the 'specific circumstances' of each of the firms, as none of the NSPs fit the criteria for a stand-alone firm at least with respect to their financing activities.

All the private NSPs are linked through complex ownership structures to a larger entity, while public NSPs have the support of state treasury departments to raise finance.

In both instances, the ownership structures allow lower costs of finance than would be the case if they were *actually* stand-alone entities. For instance, privately-owned NSPs can and do have access to parent company guarantees even when they raise their own debt.

PIAC therefore considers that the AER's approach should be consistent. There should not be parts of the benchmarking definition that picks up on business specifics and other parts that represent some abstracted condition (such as a stand-alone entity).

In other words, if the AER calculates the rate of return on the basis of a pure stand-alone entity, then this should also involve benchmarking each firm against an abstracted target of efficient performance that is (largely) distinct from the individual circumstances facing each NSP.

If, however, the AER adopts the position of some NSPs that the 'benchmark firm' should reflect the specific circumstances of each service provider, then the NSPs must also accept an

[22] For example, see the joint submission in response to the AER's Rate of Return Guidelines Issues Paper by Citipower, Powercor Australia and SA Power Networks, 2013, 7- 8, Table 2.

approach that also takes into account their specific corporate structures and the benefits that flow to the NSP in raising finance as a result of this corporate structure.

Similarly, the tax and imputation credits allowance would, if consistent with this approach, need to be based on the actual NSP's tax and franking circumstances.

PIAC is in fact, not advocating such an approach. What PIAC is advocating is the consistent application of the benchmarking approach and that the benchmark firm is defined in abstract terms, and is not representative of any individual firm (although it may generally represent an efficient firm in a class of firms) in each of the relevant parameters in the WACC calculation.

Further complicating the situation is the claim by some NSPs that the benchmark should not only recognise the specific circumstances of each service provider but should also be specific to a given network operated by the NSP rather than to the broader company.

However, there has been no evidence provided that NSPs seek financing at such a level of disaggregation of their business. Even if the smaller networks were operationally separate from the larger entity, they have been funded through corporate financing departments who raise capital in much bigger parcels than required by an individual network.

For example, it has been proposed (by way of example) that in assessing the efficient financing of the Wagga Wagga Gas Network,[23] the AER should regard this network as a stand-alone business for the purposes of applying suitable models to determine the network's efficient financing costs.[24]

The financial reports of the owners, Envestra Ltd (Envestra), however, only refer to raising significant parcels of equity or obtaining loans for new capital expenditure across their business, and most capital raising has occurred in parcels with a value in excess of $150 million. They do not refer to raising capital for specific projects such as augmentation of the Wagga Wagga gas network.

Indeed, raising finance specifically for capital works on an established small network (not purchasing a new network) would be a very strange thing for Envestra to do.

The AER has allowed new capital investment in the Wagga Wagga gas network of some $22 million across the 2010-15 regulatory period on a regulated asset base of some $60 million (at 2010).[25] This is in the context of a total projected investment by Envestra in its gas networks of

23 The Wagga Wagga gas network is now owned by Envestra Ltd, while another gas company, APA, holds significant equity holdings in Envestra.

24 This is not to say that the size of an individual network may not have an impact on unit operating costs, for instance. The discussion here relates to the efficient raising of capital.

25 AER, *Wagga Wagga natural gas distribution network, access arrangement proposal, 1 July 2010–30 June 2015 – Final Decision*, March 2010, 15, Table 3.3. Envestra purchased the Wagga gas network from Country Energy in 2011.

some $1,000 million[26] i.e. the Wagga Wagga network investment represents about 2 per cent of the total capital investment program, and it would be surprising if its requirements impacted on the financing approach of the total Envestra business.

In PIAC's view, therefore, the AER is quite correct in its aim to use the smallest number of definitions for a benchmark firm and only distinguish these when/if there are materially different degrees of risk. For example, there may be material differences between gas and electricity transmission companies in terms of their risk parameters and, therefore, their cost of capital.[27]

That is, it is essential that these 'material' differences can be demonstrated empirically for them to qualify for consideration by the AER as requiring a separate benchmark.

For example, as noted above, there has been considerable discussion about the importance of the regulator setting different benchmarks and/or adopting different approaches to assessing the cost of capital based on the size of the firm (or even the size of the individual network). However, no one has been able to demonstrate what is meant by the relevant 'size' of the business; is it defined by revenue, profit, energy volumes or by customer numbers? Additionally, what is the proposed flexion point between a large and a small business and has this too been empirically justified?[28]

The argument has also been put that larger businesses could not (at an efficient cost) raise all the required capital at the start of the regulatory period, and therefore, the 'on the day' approach is not appropriate to reflect their circumstances.

PIAC considers there is some validity in the argument that a very large network business could not efficiently or prudently raise all its funds in one short period.[29]

However, the evidence is that the smaller utilities also find it more efficient and prudent to adopt a diversified portfolio debt over time with varying maturities and also adopt a variety of approaches to raising equity funds.[30]

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26 See Envestra, *Standard and Poor's upgrades Envestra's credit rating to BBB, Media release,* 24 May 2013, <www.envestra.com.au/_dyn/media/r949/news/article/attachment/408/S%26P%20upgrades%20Envestra's%20credit%20rating%20to%20BBB.pdf>.

27 Although this appears to be off-set in part at least, but the relatively lower ratio of capital investment to the RAB for existing gas NSPs compared to electricity NSPs, potentially providing for better cash flow and profit outcomes (EBIT or NPATper cent).

28 An argument could be made with respect to the relative administrative costs of raising finance; given these may be largely fixed costs. However, the costs of raising finance are captured in the allowed operating expenses, and the impact of size on financing costs can be assessed as an operating cost rather than in creating different benchmarks for the efficient financing arrangements.

29 This claim was made by the ENA and other NSPs, see AER, as above, n 1, 48.

30 This includes increasing equity from existing and/or parent company, dividend reinvestment, additional share offerings to existing shareholders.

Examination of the annual reports of the smaller privately-owned network businesses (such as Envestra, APA, SP AusNet, United Energy (Duet)) all indicate that they have already put in place, or are successfully moving toward, a portfolio approach to debt raising[31] and using dividend reinvestment schemes as one means to access relatively low cost equity funds.

Therefore, there is no evidence to show that smaller network firms are in practice adopting significantly different approaches to financing to the larger ones.

As a result, PIAC suggests that if the AER were to adopt a portfolio approach as its primary approach in the Guideline, then this would be compatible with the practices of larger firms and would not disadvantage smaller NSPs, which are progressively adopting the same approach.

Envestra, for instance, has suggested in their submission (as reported by the AER) that current debt financing practices might be a product of the AER using the 'on the day' approach.[32] However, they have not sought to implement a financing approach of raising all their debt at the start of the regulatory period as implied by the 'on the day' approach. Rather, Envestra has, in practice, moved increasingly towards a portfolio approach of different debt instruments with different tenors and different maturity dates.[33]

The difference is, perhaps, that Envestra currently applies a risk management strategy of locking in the risk-free component of the regulatory debt and equity allowance at the time of the regulatory determination through interest rate swaps. This may change under a portfolio approach to the regulatory cost of debt, but does not, per se, make the application of the portfolio approach a cause of additional risks and costs.

Q5.1: Which of the four broad approaches to combining information to determine a return on equity is preferred and why? Are there additional broad approaches that we should consider?

The determination of a single point estimate for return on equity that draws on multiple sources of information is a vexed issue that cannot be adequately solved by some simple mathematical formulation (such as taking the average or median of the different models or information sources).

If each of the models considered is treated as equally valid, then each estimation of the return on equity is equally valid and there is no a priori way of distinguishing between them; a statistical figure such as the average is meaningless for discrete data. On the other hand, if the various models are given different weightings, the argument then shifts to one of proving why model A had a weighting of X and Model B a weighting of Y. It is a dead end.

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31 Generally, the companies report that finance has been obtained at substantially lower interest cost than the regulated allowances, reflecting inter alia access to overseas debt and equity markets, and parent guarantees.

32 AER 2013, as above, n 1, 48.

33 See for example, Envestra Ltd, Annual Report 2012, 2.

Inevitably, the AER will have to exercise its regulatory discretion, although it is yet to be established if in exercising this, it is open to even more appeals through the Tribunal process;[34] particularly where the AER is exercising its discretion to reject and replace a single point estimate provided by the NSP in its initial and amended proposals.

PIAC notes with concern here that while the Rules provide for the AER to use multiple models in some form, it is also open to the NSP as the initiator of the process, to propose a cost of equity based on any combination of models and data sets in the Guideline, or even some alternative model or data set that is not in the Guideline (albeit with an obligation to 'justify' its choices).

With respect to the assessment of the 'four broad approaches' set out in section 5.5 of the Consultation Paper,[35] PIAC notes that the AER intends to hold a further workshop prior to the publication of the draft guideline and the draft guideline will contain the AER's preliminary views on this.

Noting this, however, PIAC remains of the view that the second option provides the better outcome within the framework set out in the NER, NGR, NEL and NGL. It combines consistency and transparency, with some flexibility to adapt to significant changes in circumstances and scope for the AER to exercise its informed and reasoned discretion in these circumstances.

In PIAC's view, Option 1 fails to provide sufficient flexibility, particularly given the limitations of all the modelling and data collection processes (albeit some much more than others) and the reality that the national and world economies are in a state of flux.

Option 3 accesses different models, however, in locking in percentage weights for the various outputs, it ultimately limits the discretion of the regulator to respond to changing conditions in the same way as Option 1 does. On the other hand, Option 4 leaves considerable discretion to the AER (and also to the NSP proposer in the future), but little transparency about the final choice of a point estimate.

This process would potentially, therefore, have major risks for the AER through the appeals process and would marginalise consumers' input into the process. It also considerably increases the risks of 'gaming' the modelling approach by selecting at each determination the model that generates the highest figure, even if it is not necessarily the most appropriate model for the circumstances.[36]

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34 Refer to n 13 for details of the likely changes to the Tribunal's obligations that may affect this.

35 Section 5.5 sets out four broad approaches as follows (1) The use of one model (2) The use of one primary model with reasonableness checks informed by other models and data (3) use of multiple models with pre-set weightings on the outputs, (4) use of multiple models and other information with no pre-set weightings so the choice of the final point estimation is a matter of regulatory discretion.

36 For example, in the AER's 2009 investigation, page 337 (n 11), the AER discusses the instance where the network's advisor recommended the AER consider the outputs of the Black CAPM model (as an alternative to the Sharpe-CAPM model), even though the network's own analysis indicated that the Black CAPM was inferior to a number of other options such as the Farma-French model and the Dividend Growth Model.

Under Option 2, PIAC suggests that the Guideline would:

1. set out a primary model that best meets the general criteria of being widely accepted by economists and regulators, is applicable to Australian conditions under a reasonable range of economic conditions, is stable and not overly sensitive to variations in component inputs and which draws on data inputs that are relatively robust and well established;

2. identify known strengths and weakness of the primary model, in particular, whether there are circumstances where the primary model has demonstrated some predictive weaknesses, particularly relative to other options (see point 3 below);

3. identify alternative models and sources of data that could be used to assess the reasonableness of the outputs of the primary model (given the input assumptions and known strengths and weaknesses of these other models) and/or have demonstrated a consistent ability to have more predictive value than the primary model in unusual economic circumstances; and

4. clarify any specific circumstances, which must be substantive, and which may cause the AER to give more weight to various alternatives to the primary model (for example, when expected economic conditions are markedly different to the historical conditions that underpinned the model).

While not perfect, as noted previously, PIAC concludes that Option 2 provides the best balance of certainty, flexibility to respond to special circumstances and transparency. As such, it will best promote consumers' confidence and participation in the regulatory determination processes while also contributing to positive outcomes for consumers. PIAC believes such additional certainty will also be in line with the expectations of investors, at least those investors interested in long-term stable returns, which should be the target of NSP fund raising activities.

Hopefully, it will also minimise what has now become a continual and almost automatic process of appeals to the Tribunal against the AER's decisions, and thereby complement the most recent proposals for changes to the NEL and NGL that will emphasise the Tribunal's obligation to make decisions in the long-terms interests of consumers [37]

Q5.2: How can the various information sources relevant to estimating the return on equity be brought together transparently?

PIAC has recommend Option 2 (above) as the preferred approach. As such, the question of how various information sources can be brought together is less important, than under Options 3 and 4.

PIAC agrees with the AER that the proponents of using multiple models and data options (such as in Options 3 and 4) have not indicated how they would expect the various and sometimes quite disparate outputs to be brought together into a single point estimate for the cost of equity.

[37] See SCER Bulletin, six, 6 June 2013, n 13.

As the AER also suggests, the NSPs are correct in highlighting the importance of sound reasoning in bringing the model outputs to a single point estimate, a requirement that will sit with them, as the initial proposer (should they adopt this approach) as much as it sits with the AER.

But how is this to be done transparently? What comfort could future consumers draw about the process by which the NSP (as proposer) and the AER (exercising its discretion) come to a single point estimate from the range of outcomes and that such a selection was non-biased?

Given that NSPs will be the initiators of the revenue proposals, PIAC believes that the NSPs need to clearly articulate how they consider these various models and data sources would be brought together in the Guideline and how they propose to do so in their own future revenue proposals to the AER.

Without a clearly articulated method for bringing the outputs of the models and other information together, including how such a method will manage the 'cherry picking' risks that the multi-method approach places on consumers, the AER should not include the approaches set out in in the Consultation Paper as Options 3 and 4 within the Guideline.

Q5.3: Do stakeholders agree with our preliminary position that is not feasible to change the weights placed on different return on equity models (over time) based on differing market conditions, industry segments or firms?

Again, as PIAC's preference is for Option 2, the question of varying the weights applied to different models is of less relevance, although understanding the strengths and weaknesses of the alternative models may assist in the event that primary model outputs are not aligned (to a significant degree) with market data and other reasonableness checks.

If the AER was to proceed with Options 3 or 4, then PIAC agrees with the AER that it is not feasible to change the weights placed on different models based on different market conditions, industry segments or firms.

This is a complexity that is not warranted given that all the models and data sets will have weaknesses in a number of areas. There is no simple answer to what weights should be given to different models under different conditions.

For example, the AER quotes the Brattle Group whose report (on behalf of the Australian Pipeline Industry Association) suggests, inter alia, that using a dividend growth model (DGM) may be 'more appropriate' in determining the cost of equity during periods of average stability in industry growth forecasts.[38] Even if this proposition is accepted uncritically (see footnote below), it begs the question as to what extent should the weight of the DGM model be increased relative to other models and, as a corollary, to what extent should the weights on other models and data be decreased?

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[38] AER, as above, n 1, 44. The AER also notes that the Brattle Group paper suggests elsewhere that using dividend growth models is not appropriate during periods of average prevailing risk-free rates and average market volatility – conditions that would be quite consistent with a 'period of average stability in industry growth forecasts'.

Absent considerably more analysis of alternatives and their relative weights under different conditions, analysis that produces more convincing and less contradictory conclusions than is currently seen in the literature, consumers will have little confidence in a process that lacks any theoretical foundations, appears arbitrary and overly complex and generally fails the criteria set by the AER for assessing models[39]

The criteria in section 2.4 should apply not only to the individual models and data, but also to the way in which the outputs of multiple models and data are combined to form a single point estimate. The Options 3 and 4, generally fail these criteria—particularly so if weights are allowed to change from one determination to the next in some arbitrary way.

As a final comment, if Option 3 or 4 were to be adopted, it is important that any correlations in the assumptions be well understood. If an alternative model draws on much the same inputs, then there is a risk that it adds little to the process and by weighting equally with similar models, will bias the final outcome.

Q5.4: What are the benefits of using financial models to estimate the return on equity for an average firm before estimating it for a benchmark firm?

PIAC agrees with the conclusions of the AER. There would have to be substantial and demonstrable benefits of adding an additional complex step in the process of estimating a return on equity for an average firm before estimating it for the benchmark firm. Furthermore, it is unclear what is meant by the 'average firm' or how it is relevant to the primary objective of finding the efficient cost of capital for a benchmark efficient firm.

Moreover, as stated by the AER, 'there is a degree of imprecision inherent in the various return on equity models currently available'.[40] PIAC cannot see the point in adding an additional step that will not add to the accuracy of the ultimate benchmark cost of equity nor provide any significant additional insights into the analysis.

Comments on Questions in Appendix F*:*

QF.1: Should the 'technology bubble' and the GFC or any other periods be removed from the estimation period?

The AER seeks comments on whether events such as the 'technology bubble' and the GFC should be removed from the estimation period for the assessment of the market risk premium.

Data taken from the recent Reserve Bank of Australia's (RBA) *Statement of Monetary Policy* (May 2013) indicate just how significantly the GFC has impacted on important economic parameters such as the price earnings ratio and bond spreads. This is illustrated in the two charts below (noting that Figure 1 is based on US data).[41]

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39 As per section 2.4, p 20 of this submission.

40 AER, as above n 1, 44.

41 Reserve Bank of Australia, *Statement of Monetary Policy, 2013, Domestic Financial Markets,* May 2013.

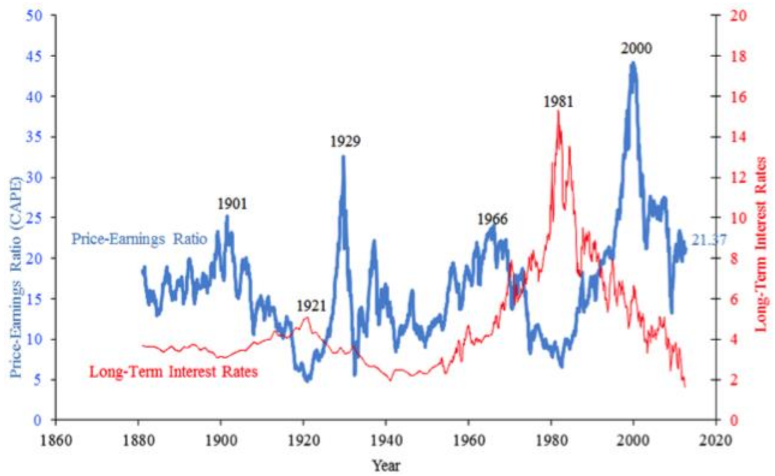

Figure 1: Robert Shiller's plot of the S&P composite real PE ratio & interest rate 1871 – 2012 (update of R Shiller's 2005 book, *Irrational Exuberance*).

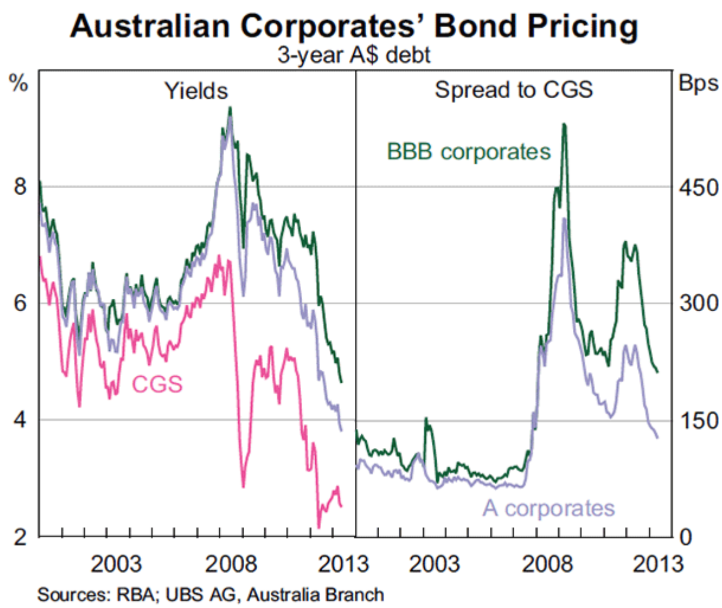

Figure 2: Australian Corporate's Bond Pricing.

It is tempting therefore to 'remove' the affect of the GFC from the historical averaging process.

However, such action should be approached with considerable caution, and perhaps removal of the data is best treated as a 'scenario' rather than the main analysis, at least in the first instance.

The criteria for removing data from a data set should in principle be set in advance, not retrospectively, and be clearly articulated. It is not enough that it is inconvenient because such 'rare but high cost' events are 'legitimate' events in the real world, and businesses and consumers alike must manage them.

Similarly, when financing costs are significantly below the mean, as the risk-free Commonwealth bonds currently are, it is important that they are not excluded.

Importantly, Figures 1 and 2 above also demonstrate that the various measures fairly quickly revert back to numbers that are well within their historical ranges. This illustrates that it is too early to suggest there has been some sort of permanent shift in the economy, a shift that would require revisiting parameters derived from historical analysis.

In addition, if the GFC data is excluded, a case could also be put (based on Figure 1, above), that the period of very high interest rates in the early 1980's should also be removed. This demonstrates that it is difficult to draw the line on what is in and what is out. Excluding data from a data set is opening a Pandora's box unless there is clear evidence that the data is incorrect or corrupted.

In the case of the calculation of the MRP, which takes a very long view of the equity market, there is even less rationale for removing any of the outlying data, however outside the normal range it appears to be (and assuming no measurement error).

Q6.1: Do you support our proposal of having a single approach for estimating the return on debt should be used for the definition of the benchmark efficient entity (for each definition if more than one benchmark is used)?

The cost of debt is one of the largest single cost components in the revenue determination, accounting for some 30 to 40 per cent of the overall revenue allowance[42] and perhaps not surprisingly, one of the most contentious and litigated.

PIAC therefore welcomes the prospect that the rate of return guideline, and the processes followed by the AER to prepare the Guideline, will provide consumers with some certainty about the future and a restoration of confidence in the regulatory process.

However, PIAC also recognises that there are no simple methodology that will give the 'correct' answer such that the allowed cost of debt will exactly match the future cost of debt of an efficient entity—there can be no such forecast accuracy.

The best hope is that on average over time (and across regulatory periods), there will be a balance between the different interests, that is:

- in some periods the outcome may favour the NSPs (the allowed cost of debt will be higher than their actual cost of debt) while in other periods the outcome will favour consumers; and
- the swings between these two positions are sufficiently 'smoothed' by the modelling process that networks are not discouraged from long-term investments in assets and consumers are not disadvantaged by large price movements.

PIAC's position on this matter reflects a desire for a fair balancing of interests in the future and the restoration of consumer confidence in the regulatory processes. The most effective way to

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42 Assuming a gearing ratio of 60 per cent, and that the cost of capital makes up some 50 per cent of the total cost base.

achieve this appears to be largely aligned with the AER, that is, the adoption in the Guideline of a single, portfolio based approach. This is explained further below.

PIAC notes that while the Rules do not prescribe an approach, the AEMC has set out three broad approaches to estimating the return on debt that could reasonably be contemplated by the AER as contributing to the achievement of the rate of return objective. The AER summarises these as follows:

- the return required by debt investors if it raised debt at the time of or shortly before the making of the determination for the regulatory period;

- the average return that would be required by debt investors if it raised debt over an historical period prior to the commencement of the regulatory year in a regulatory period; or

- some combination of above.

Although the AEMC has provided considerable discretion in the Rules, PIAC strongly supports the AER's proposal to have a single approach defined in the Guideline for estimating the return on debt. The main concern here is the opportunity for gaming the process (see below) across regulatory periods, such that there is a constant bias towards higher estimates of the cost of debt.

PIAC notes, however, that the choice of a single approach to the cost of debt calculation must be based on a rigorous consultation and assessment process. While it is important to avoid 'chopping and changing' between models, it is also important that the final approach is adopted only after each option is objectively considered in the process of finalising the Guideline.

PIAC believes that the AER is undertaking such a process prior to the finalisation of the Guideline and will therefore be well placed to (a) select a primary approach for inclusion in the rate of return guidelines, (b) have an understanding of the strengths and weakness of alternatives, and (c) be in a position to critically assess alternative approaches if they are put forward in the NSPs' initial regulatory proposals.

More particularly, PIAC comments:

- The AER has correctly identified the major concern of consumers with the 'menu approach'; that is, allowing each NSP to select the approach that best suits them at the time of the determination from the three options described previously (on the day, trailing average, hybrid).

  A 'menu approach' would fundamentally undermine attempts to reach a balance between the interests of consumers and NSPs by enabling an NSP to select the methodology in each determination that would achieve the highest debt allowance. There would be no averaging out of 'errors' over time, a prerequisite for consumers to accept the process as fair and reasonable.

- The AER is right to be cautious about establishing multiple benchmark efficient entities. Benchmarks are essentially abstracted values or concepts and, when used in the regulatory context, are not generally intended to replicate the activities of individual companies. In fact benchmarking would lose its power as an incentive for efficiency if it did so.

- Multiple benchmarks will also greatly complicate the regulatory process and hinder consumer involvement for very limited, if any, improvements in the accuracy of the satisfying the rate of return objective (i.e., the efficient financing for an efficient NSP).

  Separate benchmark entities should only be established (if at all) following a clearly demonstrated difference between the approaches to debt that reflect substantive underlying drivers and manifestly different risks. For example, raising debt regularly (say quarterly) versus periodically (e.g. two debt raisings in one year, none in the next etc.) is not a sufficient reason to establish two benchmarks if both entities can prudently and efficiently adopt a portfolio approach that approximates the single portfolio model.[43]

  As any benchmark model is an idealised abstraction, the AER should avoid attempts to create a spurious level of accuracy by establishing multiple benchmarks reflecting individual firm characteristics.

Notwithstanding our strong support for a single approach, PIAC acknowledges that there may be important transitional issues in moving from the current arrangements to the recommended approach.

The transitional steps must be devised so as to retain the confidence of all stakeholders in the process. For instance, a transition from ‘on the day’ approaches to a form of portfolio approach (e.g. historical averaging) may mean that consumers have no opportunity to recover the over-recovery that most NSPs are enjoying under the current determinations on the cost of capital. Given this, providing any form of ‘compensation’ to NSPs for transitioning to a new and fairer system would be seen by consumers as inequitable and not in their long-term interests; it would ignore the benefits already received by the NSPs and add further costs to consumers over and above what they have already been burdened with.

Q6.2: How do the “on the day” approach, trailing average portfolio approach and hybrid approach to estimating the return on debt compare in terms of promoting efficiency?

Each of the three approaches has their strengths and weaknesses.

However, the experience of the last few years suggests that the ‘on the day’ approach is too vulnerable to volatility in the debt and equity markets. The greater the volatility, the more variance there is in the allowed cost of debt arising from the particular selection of the short-term averaging period.

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43 This does not mean that the firm(s) must adopt a portfolio approach in practice, merely that it would be a feasible, prudent and efficient approach for them to do so. Moreover, given that any cost of debt model is an abstraction from reality, as it includes (for example) idealised maturity periods and regular amounts and timing of debt placements, then having a common single benchmark approach will be generally as adequate a representation as multiple benchmarks (each idealised too).

This issue with the 'on the day' approach was starkly illustrated in the last NSW network determinations, which following appeal by the NSPs to the Tribunal, came at a cost of some $2 billion to NSW consumers.[44] The Tribunal turned down the AER's selected short-term averaging period and allowed the averaging period chosen by the NSPs in their proposals.

The Tribunal's decision occurred despite the significant impact on consumers and even though the AER's averaging period was much closer to the time of the determination and, therefore, more reflective of the principles behind using the 'on the day' averaging approach which is intended to reflect the costs of raising the debt at the time, or shortly before, the making of the distribution determination.

Nor is PIAC convinced of the argument for 'on the day' that has been put by some regulators,[45] namely that the cost of debt assessment should recognise the costs facing a new entrant network owner that will have to raise the capital at the start of the determination. In the first instance, this is not a very likely scenario for a mature monopoly market. In the second instance, if the regulated cost of capital is less than that faced by the new entrant, then the new entrant will pay less for the asset and therefore be no worse off from an overall cost perspective.[46]

It can be a matter of little surprise that organisations such as PIAC are therefore wary of any continuation of the vagaries of the 'on the day' approach. It is notable, however, that NSPs are now also supporting a change to the use of various forms of historical or portfolio approaches.

This change of heart may be a reflection of the fact that interest rates have now collapsed below their long-term averages, and this is already flowing through to significant reductions in the allowed rate of return in the AER's determinations since 2011.

The choice going forward for consumers is a difficult one. Having been on the 'wrong side' of the last round of determinations in most states, adopting a trailing average or hybrid approach will mean that consumers also forgo the compensating benefit of the lower than average interest rates in the next round of determinations.

Nevertheless a choice has to be made, particularly as PIAC supports the AER's proposal to provide only a single approach to the cost of debt calculation in the guidelines.

This choice is to forgo the prospect of some compensation for paying more than the efficient cost of capital (particularly cost of debt) in the previous regulatory period, and accept that the long-term interests of consumers lie in adopting a more stable and predictable trailing average /portfolio approach, that may:

- reduce the volatility in network pricing both within and between regulatory periods;

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[44] See Productivity Commission 2012, *Electricity Network Regulatory Frameworks,* Draft Report, Canberra, Table 5.2, 201.

[45] For example, IPART includes the concept of a 'new entrant' as one of its three characteristics of a benchmark utility, IPART 2012, n 9. 12.

[46] This argument is articulated in ACCC Regulatory Development Branch, as above n 2, 48.

- therefore allow consumers and businesses to plan more effectively, with efficiency benefits for the broader community;

- reduce the scope for gaming the regulator (and consumers); and

- encourage the NSPs to focus on ways to perform better than the benchmark rather than ways to manipulate the benchmark.

Having said this, however, it is essential that any transitional arrangements recognise that the current position unduly rewards NSPs for the cost of capital, as seen in the above average returns to shareholders (including state government shareholders) over the past few years. As highlighted previously, there is no need, in terms of financial resilience of the NSPs, to compensate the NSPs for costs or loss of expected earnings from this transition. If consumers have foregone lower prices in the past as a result of the regulatory framework, it is unreasonable to expect consumers to incur additional costs going forward as a result of the change in the regulatory framework.

More generally, PIAC is supportive of the arguments put forward in the paper by the Regulatory Development Branch (RDB) of the Australian Competition and Consumer Commission.

The RDB concludes after considerable analysis of all the options including the hybrid option, that the simplest, most transparent approach that provides a better balance between the interests of consumers and investors over the long term and is consistent with the objective of setting a benchmark efficient cost of debt with adequate incentives for the NSPs, is (simplistically):

- a portfolio approach;

- using historical information to establish the forward yield curve for the cost of debt and for the risk free rate;

- taking a simple average, not a weighted average based on the debt issuance profile; and

- set at the start of the determination period, for the whole determination period (with no annual adjustments).

PIAC understands that all other things being equal, the RDB approach would provide appropriate returns when considered over multiple regulatory periods,[47] and therefore consistent with:

- the long economic life of the NSP assets;

- the expectation of debt and equity investors that investing in utilities will create stable lower risk returns that, in turn, are important to a balanced portfolio;

[47] See ACCC, as above n 2, 30-35 for a detailed example of how a single value without annual updating will 'self correct' over a number of regulatory periods is provided.

- the strategic direction of the AER to encourage a longer-term view of investment planning that extends beyond the current regulatory period; and
- the equitable allocation of risks between investors and consumers.

It also has the important benefit of minimising questions around the data, as the great majority of the data is based on published historical information. The underlying assumption is that taken over a sufficient period of time, the debt market in the future will on average be similar to the debt market in the past (mean reversion hypothesis) despite volatility year on year.

There is some argument, however, that the GFC and also the subsequent series of economic crises across Europe, have resulted in a step-change in markets that makes void the underlying assumptions behind using historical averages to forecast the future (including the assumption of 'mean reversion').

PIAC's view is that it is too early to make such a claim, and therefore it is reasonable for the Guideline being currently developed to apply conservative economic assumptions that have held in the past.

Q6.3: What are the considerations that we should have when setting the gearing level?

Actual gearing is a dynamic process. For example, PIAC notes the comments by the AER that 'the actual optimal value of debt and equity for any given firm is dynamic and dependent on a number of business-specific factors'.[48]

Consistent with this, it would appear that most private NSPs have been deleveraging for some years despite the relatively low cost of debt and they report targeting gearing levels ranging from around 66 per cent to 78 per cent and declining in each instance.[49]

Most regulators in Australia are continuing to apply a gearing ratio of 60 per cent, on the basis that there is no particular evidence for any alternative benchmark for an efficient NSP.

More generally, PIAC considers that it is important to ensure that the gearing level is such that it is generally consistent with a benchmark credit rating of BBB+ and with sufficient cash flows being available to the business to continue to invest (all other things, such as management competency, being equal).

PIAC also notes that the benchmark ratio of 60 per cent is conservative in the sense that it increases the probability that the allowed cost of capital is greater than the actual cost of capital, particularly when the entity has parent guarantees.[50] This embedded benefit to the NSP should be recognised in the discussion of risk sharing.

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48 AER, as above, n 1, 53.

49 For example, see report by Angela Macdonald-Smith, n 21. The average net debt/regulated asset base for 4 private network companies (Spark Infrastructure, DUET, Envestra and SP AusNet, was approximately 73 per cent in FY13 and forecast to decline to approximately 68 per cent by FY16..

50 This is because the cost of debt is lower than the cost of equity, therefore the higher the gearing level, the lower the overall cost of capital derived from the weighted average of the two.

QG.1: If a portfolio approach is adopted, then should a trailing average that applies to the entire rate of return on debt be preferred to the hybrid portfolio approach?

The AER reports that some stakeholders suggest that under the portfolio approach the trailing average should apply only to the debt risk premium (DRP) calculation and not to the entire rate of return on debt. The stated rationale for this hybrid approach is that it is possible for the NSP to 'lock in' the risk-free rate for the duration of the regulatory period using swap contracts.[51]

On the basis of the information provided, PIAC would oppose the use of a hybrid approach. In PIAC's view, the hybrid approach artificially and unnecessarily separates the way in which the risk free, and the risk premium components of the cost of debt are calculated. The problems of this separation will be exacerbated to the extent that there are any interactions between the two parameters in the 'real world'.[52]

Whether or not this is possible, it may well be an expensive assumption in terms of both the costs of the swap and the subsequent re-financing risk. PIAC agrees with the AER that the hybrid approach adds no obvious value for an efficient benchmarked firm and may increase refinancing risk compared to the natural hedge provided by the overall portfolio approach to the cost of debt.

Moreover, the hybrid approach adds a level of complexity and reduces the transparency of the process. It will tend to over-estimate the final costs and create greater volatility in the outputs compared to the overall portfolio approach as demonstrated by the AER's analysis.

QG.2: If a portfolio approach is adopted, should a simple (unweighted) trailing average be preferred to a weighted average?

QG.3: Should the AER adopt annual updating (either within the period or via a true-up), and if so, how could this be made to work in practice given the implementation issues?

These two issues have been discussed previously in this submission. PIAC does not support the weighting of the components of the portfolio; this would be seeking a level of precision in the outputs that is not warranted by the accuracy of the inputs and the models.

In addition, it appears that the weighting would be based on the forecast profile of capital expenditure. However, the NSP has no obligation to actually invest capital in accordance with that profile, and the weightings could open the door to further gaming of the actual investment profile—an outcome that should be avoided.

For example, the capital expenditure forecast might forecast a significant spend in year 2 of the determination period, and the weighting would attempt to capture this in the assumed profile of borrowings. If, in practice, the expenditure were delayed then there would be a mismatch

51 AER 2013, as above, n 1, 106.

52 For example, in certain conditions such as high market stress, movements in the risk-free rate will be partly off-set by contrary movements in the debt risk premium, providing a more stable overall cost of debt. Where the two components are assessed in different ways as proposed under the hybrid approach, it is difficult to adjust for these interdependencies.

between the financing assumptions and the actual expenditure. So little is to be gained in terms of financing and much to be lost by adding this, and any other additional complexity.

QG.4: Is there a need for transition arrangements and if so, what is the form in which it may be applied?

PIAC considers that the implications of transitioning to a portfolio (trailing average) approach need to be carefully considered and tested. However, it is not yet convinced that the risk for the NSPs is greater than the volatility that would be created for the NSPs and the consumers through a continuation of the 'on the day' approach.

Currently, the regulatory cost of debt is set on the basis of 'on the day' and fixed for the 5-year regulatory period. As such it bears little relationship to what NSPs are currently doing to manage their debt through various tenors, volumes and maturity dates. In other words, there is no evidence that NSPs are acquiring debt to align with the current regulatory benchmark approach.[53]

To what extent, therefore, would a change to a portfolio approach expose the NSP to additional risk as measured by the total WACC allowance compared to the current base case of 'on the day' assessment? PIAC would suggest that, in fact, a portfolio approach would be closer to the NSPs' actual practice and therefore be less of a mismatch than the current approach. It is not clear why special transitional arrangements would be required to 'adjust' to a methodology that is closer to the reality of NSP financing than the current approach.

As stated previously in this submission, it is also important to remember that consumers have been on the 'down-side' of the current regulatory determinations. It is not unreasonable for consumers to expect NSPs to wear some risks associated with a change in approach.

Nevertheless, PIAC accepts that the question of additional risk is an empirical one and the impact of transitioning should be carefully studied and 'stress' tested.

QG.5: Would using a range of debt forms result in better decision-making?

As noted by the AER, NSP's are accessing a wide variety of debt forms, some more exotic than others. However, PIAC considers that in setting an efficient benchmark, it is better for the AER to focus on effective but simple arrangements with little intrinsic risk, to represent the benchmark efficient NSP.

It is then up to each NSP to 'beat the benchmark' by accessing other forms of debt, and it is clear that NSPs are (quite appropriately) doing that.

[53] With the possible exception of some NSP's locking in the risk free rate via interest rate swaps. However, this would only be significant to this transitional argument if the NSPs purchased interest rate swaps for periods longer than the 5-year regulatory period. It is questionable why an efficient business would seek to do that given the cost of capital, including the risk-free rate will be re-set in the next regulatory period, and swaps based on longer periods would risk being at rates in excess of the prevailing market.

In effect, this is another area, where the NSPs financing through their parent companies or government treasuries can obtain a substantial premium on their allowed costs.

However, it is also important to note that the NSP and/or its parent company also bear any risks arising from these alternative approaches (including counter-party credit risks). For instance, any additional risks taken on by the NSP should not feed into any modification of the benchmark beta or credit rating, nor should any losses be considered a pass through cost.

Having supported the ‘simple’ approach, PIAC would also encourage the AER to closely monitor trends in debt financing and how these trends have affected the costs of debt relative to the current approach. For instance, it is clear that NSPs are increasingly availing themselves of overseas debt sources, at significantly lower costs than the regulatory allowance. For instance, Envestra Ltd states in their 2012 Annual Report:

> We were again active in the capital markets, with two US Private Placements completed. $350 million of 10, 12, and 30-year bonds were issued in June and July 2011…A further issue of $196.5 million of 10 and 15-year bonds was agreed with USPP investors in March 2012 to re-finance domestic bonds maturing in August 2012 and to replace bank facilities.[54]

This highlights the dynamic and international nature of the debt markets, with international sources replacing Australian debt providers.

QG.6: Should the AER rely on Bloomberg (or other third party) or develop and apply its own AER-developed dataset? How can the issues arising from either option be mitigated?

The limitations of Bloomberg’s data have been canvassed previously. Nevertheless it is a well-recognised source of information, and one that has been used over a considerable period of time by regulators and businesses alike.

The AER’s main concerns is with the continuity of Bloomberg series in the future and its capacity to provide sufficient data for determining yields (for 5 or 10 year periods), particularly given the difficulties created in the past by the cessation of the 10 year bond yield curve.

However, it is PIAC’s view that the AER should persist with the Bloomberg data, particularly if the forecast period for the yield curve is reduced to 5 years from the current 10 years; a move that will also have considerable benefits for the AER in terms of the quality of the various data sets.

Nevertheless, it would be wise for the AER to further investigate the option of setting up its own data set, and perhaps testing it in parallel to the Bloomberg data series. At some point, it may become either necessary or preferred.

Q7.1: Should we still estimate gamma as an economy wide measure. Alternatively, should we seek to narrow the gamma benchmark? If so, what is a more appropriate benchmark?

Q7.2: To what extent do stakeholders support the use of a definitive source of evidence, even where it has demonstrable shortcomings? Alternatively, to what extent do

54 Envestra Limited, Annual Report, 2012, 2, <http://annualreport.envestra.com.au/>.

stakeholders support the use of a wider range of evidence, having regard to its strengths and weaknesses?

As noted by the AER, the calculation of gamma is a very inexact science and the experts have provided widely different results. In addition, the AER cannot look to overseas approaches for guidance, as they do not have the same taxation rules around dividend imputation credits.

PIAC's considerations are therefore restricted to a number of high-level comments and observations as set out below.

- While the Tribunal rejected the AER's proposal for a gamma of 0.65, it is hard to interpret the Tribunal as endorsing the alternative put by the NSPs of 0.25. Their view was more one that the AER had not established sufficient grounds to reject the NSP's proposal, and therefore had incorrectly used its discretion.

- The effect of gamma in the determination process is to adjust the implied taxation rate of 30 per cent. The higher the gamma, the lower the deemed taxation rate and therefore the lower the costs allowed for taxation in the determination.[55]

- Examination of the annual reports of the private listed NSPs, indicates actual Australian taxation rates substantially lower than the adjusted rates using a gamma of 0.25, and closer to the adjusted taxation rates using a gamma of 0.65, the number first used by the AER, i.e. a taxation rate of 10 per cent or less.

- Dividend imputation credits are only available to Australian shareholders for taxation purposes. There is a high level of overseas equity investment in Australian energy utility companies.

The AER should take this into account when reviewing gamma, particularly as it goes to the question (Q7.1) of whether the AER should seek to narrow the gamma benchmark from Australia wide to a more industry specific benchmark. If the proportion of overseas shareholdings is greater than average for energy utilities then this suggests a utility specific gamma is more appropriate.

Q8.1: Do you support our preliminary position of not setting a specific allowance for debt and equity raising costs, and instead, remunerating them elsewhere in the revenue building blocks?

PIAC supports this approach of accounting for the debt and equity raising costs elsewhere in the revenue building blocks, in particular, as a component of operating costs.

As noted previously in this submission, it may well prove to be the case that the cost of raising debt and equity is proportionately greater for smaller NSPs, although how much is open to further assessment.

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55 More specifically, the formula is the implied taxation rate * (1 – gamma). If gamma is 0.65, then the adjusted taxation rate is 30% * (1-0.65) = 10.5%; if gamma is 0.25 then the adjusted taxation rate is 30% * (1-0.25) = 22.5% resulting in a higher cost allowance for the NSP.

For example, given that PIAC is recommending a portfolio approach to assessing the cost of debt, it is reasonable for the NSPs to make explicit (albeit reasonable) claims for the associated costs of constructing and maintaining a portfolio of annual debt issuances.

However, recognising these greater costs in other parts of the revenue building blocks is, in PIAC's view, far preferable than establishing an alternative approach to raising debt specifically for smaller retailers (however that might be defined).

Q9.1: Should we continue to use our current approach to forecast inflation or move back to using the Fisher equation? Alternatively, should the AER use inflation swaps? Are there other approaches not identified in this paper that we should consider?

As noted by the AER, inflation is an important part of the revenue forecasting process and in maintaining the real value of the network assets.

Without further information on the outputs of the various options put forward by the AER, this is not an issue that PIAC would comment further on, other than to highlight the importance of using data that meets the criteria set out in section 2.4 of the Consultation Paper. In particular, the data should be reliable, transparent and provided by recognised and independent sources such as the Reserve Bank of Australia.

For example, inflation swaps are useful tools for the businesses, and could therefore be a relevant source of data for the AER. However, the AER would need to be confident that the swap market is sufficiently liquid to provide reliable forecasts over the regulatory period.