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Mr Warwick Anderson
General Manager, Network Regulation Branch
Australian Energy Regulator
GPO Box 3131
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Via email: rateofreturn@aer.gov.au

Dear Mr Anderson

Rate of return guideline consultation paper

Thank you for the opportunity to respond to the AER's Rate of Return Guideline Consultation Paper published on 10 May 2013.

TransGrid broadly endorses the submission made by the Energy Networks Association (ENA). TransGrid's specific positions are set out in the attachment to this letter. In summary, TransGrid supports:

- the use of the ENA's 'multiple model' approach, including the use of relevant non-model evidence such as independent expert reports, to determine the allowed return on equity;
- determining the allowed return on equity in a way that reflects market assessments of the expected overall return on equity rather than combining a forward looking risk free rate with a Market Risk Premium based on historical data;
- the use of a long term trailing average approach, including annual updating, to determine the allowed return on debt for large network businesses that already use a portfolio debt approach;
- an immediate transition to the trailing average approach for large network businesses that already use a portfolio debt approach; and
- continuing to set discrete allowances for debt and equity raising costs.

TransGrid submits that the above approaches reflect the new National Electricity Rules requirement, and Australian Energy Market Commission policy intent, that the allowed rate of return be assessed by taking into account all of the relevant evidence as well as the relationships between equity and debt and between the associated parameters.

TransGrid considers that, all things being equal, the application of these approaches best serves to minimise volatility in the allowed return on capital. This should promote efficient network business investment decisions and more stable consumer prices over time.

TransGrid

Finally, TransGrid notes that the timeframe for completing the rate of return guideline remains very tight and that TransGrid is required to lodge its 2014-15 transitional year revenue proposal, based on that final guideline, only a few weeks after the expected publication date. TransGrid also notes that there remain important aspects of the guideline, such as the question of the appropriate benchmark efficient entity, where meaningful discussions with stakeholders on the substantive issues have yet to occur. TransGrid therefore strongly encourages the AER and its staff to work as openly and constructively as possible in the time remaining in order to deliver a final guideline that provides the requisite stakeholder certainty.

Should you wish to discuss any aspect of this submission further, please contact Anthony Englund, Regulatory Strategy Manager on (02) 9284 3148 or anthony.englund@transgrid.com.au.

Yours sincerely

Philip Gall 27/6/2013

Philip Gall
General Manager, Corporate and Regulatory Strategy

Certified System Environment ISO 14001 SAI GLOBAL
Certified System Quality ISO 9001 SAI GLOBAL
Certified System Health & Safety AS 4801 SAI GLOBAL

Attachment

The new Rules and the guideline

The new National Gas and Electricity Rules place fundamentally different obligations on the AER than existed under the previous Rules. In electricity the previous Rules were prescriptive and, in gas, they were drafted in a way that promoted use of incumbent methodologies. By contrast, the new Rules require the AER to have regard to the full range of relevant methods, financial models, market data and other evidence.

An approach that does so in a transparent, predictable and replicable way is most likely to achieve the overall rate of return objective and therefore be consistent with the Rules. Such an approach would lead to more appropriate cost of capital estimates, contributing to more efficient investment signals with the potential to reduce pricing volatility for customers.

The purpose of the guideline is to set out how the AER is likely to assess the allowed rate of return in future revenue determinations using that approach. The guideline must provide as much certainty as is reasonably practical, recognising that some areas of regulatory discretion are inevitable because circumstances will change from reset to reset. However, the guideline providing as much certainty as is reasonably practical would minimise regulatory risk as well as the need to revisit every issue at the time of individual revenue proposals.

In having regard to all the evidence, it is also important that, wherever possible, the guideline looks towards the market, and what market practitioners do to gauge efficient business practices, rather than rely only on theoretical or academic approaches. The market provides the starting point for the relevant benchmark or benchmarks and that evidence must be afforded appropriate weight. In addition, the guideline should, as the Rules require, identify how the AER proposes to take into account the relationships between the costs of equity and debt and between the relevant model parameters.

Principles/criteria

Consistent with views previously expressed by the ENA, TransGrid is willing to consider additional 'principles' or 'criteria' relevant to the AER's exercise of discretion when assessing the allowed rate of return. However, it shares the ENA's concerns that the principles proposed in the Consultation Paper are not supported by, or are contrary to, the allowed rate of return objective, the National Electricity and Gas Objectives (NEO and NGO) or the Revenue and Pricing Principles (RPP). The specific concerns are provided in the ENA's submission.

TransGrid endorses the ENA's position that the allowed rate of return objective remains primary in assessing the return on capital, informed by the NEO, NGO and RPP where there is any uncertainty. Additional principles or criteria should only be included where the policy intent is clear and this would need to be adequately demonstrated by the AER.

Return on equity

Broad approach

The Consultation Paper proposes four broad potential approaches to determining the return on equity component of the allowed return on capital. TransGrid notes that the first and third of these, the use of a primary model and the use of several models with ex-ante weightings applied to them, do not appear to comply with the Rules requirement to take into account all the relevant evidence, including contemporaneous evidence regarding the weightings that should be applied.

TransGrid supports the ENA's 'multiple model' methodology. This is a preferable version of the AER's fourth approach as it has the additional benefit of a clear, robust step by step process for addressing potential differences between the rate of return estimates generated by the individual models.

TransGrid notes that the AER's second approach, the use of a primary model combined with 'crosschecks', may provide a workable methodology. However, the AER would have to make it clear how this approach properly takes into account *all* the relevant evidence. Otherwise, it would not meet the new Rules requirements. The Consultation Paper doesn't provide any information in this regard. The AER would also need to demonstrate how this approach, properly articulated, would better address the rate of return objective than the ENA's multiple model approach that TransGrid prefers.

A holistic approach

TransGrid notes that the practice of the AER under the previous Rules was to assess the required return on equity using principally the Sharpe-Linter CAPM with the relevant parameters assessed in isolation from each other and then combined. As referred to above, the new Rules require that all the relevant evidence, including the inter-relationships between the parameters and between debt and equity, be taken into account when making that assessment. This is required in order to ensure that the overall allowed return on equity is reasonable and efficient.

To this end, TransGrid supports the ENA position that the AER make its assessment principally by reference to evidence regarding the expected market return on equity rather than continuing to assess the risk free rate and market risk premium parameters under CAPM models separately, and on different bases (a forward-looking 'spot' rate for the former and a backward looking long-term historical average for the latter). This would address concerns that the AER's approach ignores the evidence that, where those parameters are relied on by market practitioners, they either incorporate or are explicitly adjusted to take into account relevant market conditions such as the current historically low interest rates. It would also ensure greater consistency with the assessment of the allowed return on debt and reduce volatility for both network business investors and customers.

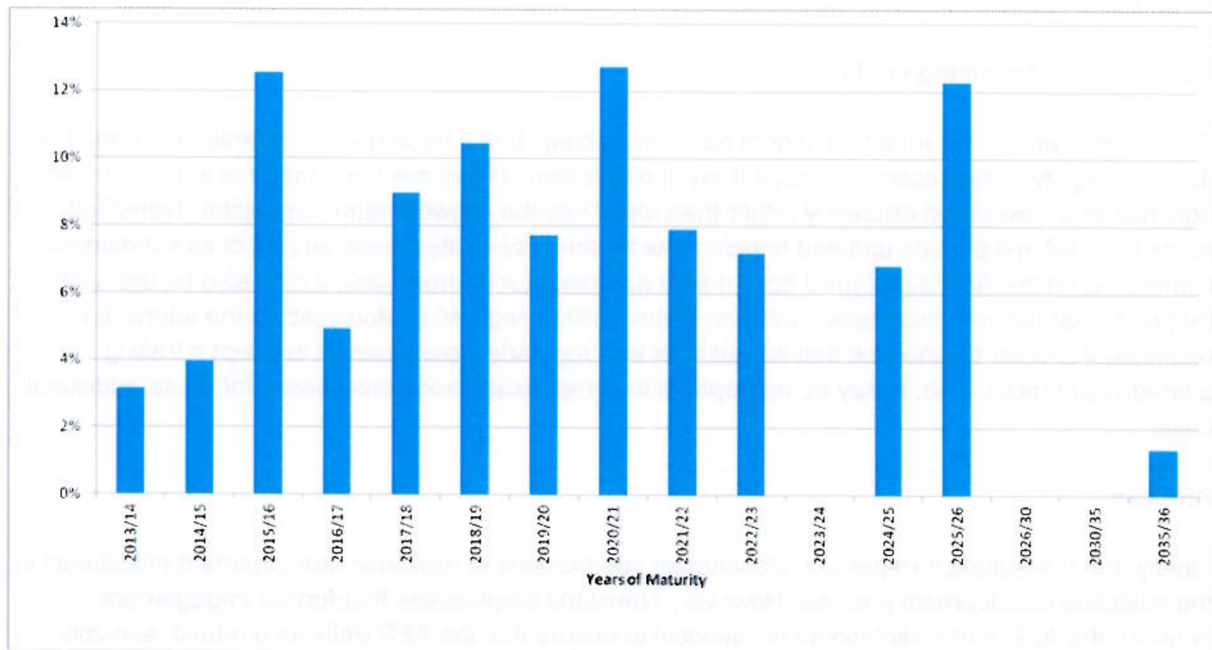
Return on debt

Methodology

The ENA's response to the AER's Issues Paper submitted that the AER should set out all three cost of debt methodologies (spot, trailing average and hybrid approach) in the guideline and leave the application of the particular methodology to be decided at the time of each network business's revenue reset. In the Consultation Paper, the regulator indicated that it may prefer to apply a single methodology uniformly and the ACCC/AER Regulatory Development Branch cost of debt staff paper suggested that the trailing average approach may be the single approach to apply.

TransGrid's position is that the AER should apply a long term trailing average approach for those large network businesses that already apply a portfolio debt approach. TransGrid is such a business and its debt portfolio comprises multiple debt instruments with staggered maturity date (summarised overleaf). Previous submissions made by the ENA and the New South Wales distribution businesses highlight that this portfolio approach is an efficient debt management practice used by large, unregulated infrastructure businesses.

Figure 1. TransGrid's current debt maturity profile (by proportion of portfolio).



All else being equal, the trailing average methodology materially reduces volatility for both network business investors and customers. TransGrid notes that those customer representatives participating in the AER's guideline development process have placed strong emphasis on this benefit. In addition, large network businesses such as TransGrid may find it problematic (as well as inefficiently expensive) to continue to refinance their portfolios, and access the relevant derivative instruments required to effectively hedge them, under the spot or hybrid approaches.

Annual updating of the allowance is necessary to maximise the benefits of the trailing average approach as end of period 'true up' adjustments are likely to result in more significant price 'shocks' for customers. Doing so allows the use of the most timely market information resulting in more efficient estimates and thereby reduces the risk of windfall gains or losses to the network business.

Transition

TransGrid notes that the purpose of transitional arrangements is to provide a mechanism (or mechanisms) to ensure that the network businesses are able to meet their new regulatory obligations in a way that doesn't jeopardise their service obligations or the opportunity to recover at least their efficient costs. Where a network business is able to meet the new obligations without that assistance, there should be an immediate transition. **TransGrid's current debt management practice is already consistent with the benchmark efficient portfolio approach and therefore only an immediate cutover would be appropriate.**

Any other form of transition has the potential to create a significant mismatch between the efficient debt management practices of network businesses like TransGrid and the regulatory benchmark approach. It would also have the effect of distorting investment decisions.

Both the two transitional methods canvassed in the guideline development process to date (the 'debt filler' approach outlined in the ACCC/AER Regulatory Development Branch staff paper and the Queensland Treasury Corporation model) would result in material under-compensation for TransGrid relative to the efficient benchmark. The 'debt filler' approach shortens the effective debt tenor below that benchmark. Analysis undertaken for TransGrid suggests that, based on monthly average corporate bond yields measured over May 2013, the QTC transitional model would result in a revenue shortfall for TransGrid in the order of $186m in net present value terms. This would not provide

adequate compensation for the staggered debt issuance and maturity dates of existing debt lines in its portfolio.

Debt and equity raising costs

TransGrid supports the retention of debt refinancing costs being treated as an operating expenditure item and equity raising costs as a capital expenditure item. These costs are material and so should continue to be assessed discretely rather than rolled into the allowed return on capital. TransGrid notes the ENA will provide updated benchmarks for the debt-related costs as part of its submission. Depending on the AER's preferred cost of debt approach (or approaches), it may also be the case that particular network businesses will face higher refinancing transaction costs in the future (for example, if smaller businesses that issued debt less regularly were required to adopt a trailing average approach). If so, it may be appropriate to compensate those businesses for those additional costs.

Process

Finally, the Consultation Paper and stakeholder submissions in response, are important milestones in the guideline development process. However, TransGrid emphasises that further engagement between the AER and stakeholders is essential to ensure that the AER delivers a robust, sensible guideline in the tight timeframe required. This is particularly critical for TransGrid which is required to submit its 2014-15 transitional period revenue proposal in late January 2014 and full revenue proposal not long thereafter.

While aspects of the guideline development process have been constructive, there remain key areas, such as the question of the appropriate benchmark efficient entity, where meaningful discussions on the substantive issues have yet to occur. To this end, TransGrid wishes to continue to work both through the ENA and directly with AER staff in order to ensure a clear, mutual understanding of those issues and the adoption of the most appropriate approaches to addressing them in the final guideline.