

Mr Warwick Anderson
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Australian Energy Regulator
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Via email: rateofreturn@aer.gov.au

Dear Mr Anderson

Rate of return draft guideline

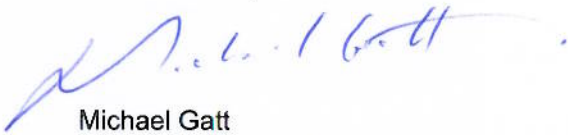
Thank you for the opportunity to respond to the AER's Rate of Return Draft Guideline published on 30 August 2013. TransGrid endorses the Energy Networks Association's (ENA's) submission in response to the Draft Guideline. TransGrid provides commentary on matters about which it has particular concerns in the attachment to this letter. In summary, TransGrid is concerned that:

- the AER hasn't demonstrated that its proposed foundation model approach to assessing the return on equity:
 - will operate in a manner that will enable appropriate regard to be had to all the relevant evidence, as required by the National Electricity Rules (the Rules); or
 - even if this is the case, does so in a way that is preferable to the ENA's 'multiple model' approach;
- the Draft Guideline doesn't provide any real guidance, and therefore, certainty, to stakeholders regarding how the AER is likely to assess estimates of the allowed return on equity (and therefore the overall rate of return) in future revenue determinations. That is, it doesn't function effectively as a guideline;
- the proposed uniform approach to debt transition risks failing to provide a return on debt allowance sufficient to meet TransGrid's benchmark efficient cost of debt during its upcoming 2014/15 to 2018/19 regulatory control period;
- the proposed move to a seven year debt tenor is not supported by the evidence;
- the AER's new 'equity ownership' approach to assessing the value of imputation credits (γ) is inconsistent with the requirements of the Rules; and
- shortcomings in the AER's engagement process risk a Final Guideline that is based on an inadequate consideration of the positions and evidence put forward by stakeholders.

TransGrid continues to support a guideline that appropriately manages rate of return volatility for its customers and shareholders. Doing so should promote efficient network business investment decisions and more stable customer prices over time. 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, please contact Anthony Englund, Manager, Regulation and Business Improvement on (02) 9284 3148 or anthony.englund@transgrid.com.au.

Yours sincerely



Michael Gatt
Executive General Manager, People and Corporate Services

Attachment

Return on equity

Inadequate justification of the foundation model approach and insufficient certainty of application

The National Electricity Rules (the Rules) specify that the allowed rate of return objective is that the rate of return for a regulated electricity or gas network business 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 business in respect of the provision of the regulated services¹. The Rules require the AER to determine the rate of return and, in doing so, must have regard to the full range of relevant methods, financial models, market data and other evidence².

In its final Rule determination, the AEMC stated that it:

expects that the [rate of return] guidelines will provide service providers and other stakeholders with an ability to make a good estimate of the rate of return for particular businesses at particular points in time. The Commission recognises that the guidelines could allow this to occur in a number of ways, including through the way the methodologies are explained and/or by providing ranges of possible outcomes³.

TransGrid has two concerns with the Draft Guideline in relation to the above:

- the AER hasn't demonstrated that its proposed foundation model approach to assessing the return on equity has appropriate regard to all the relevant evidence as required by the Rules or, even if this is the case, does so in a way that is preferable to the ENA's 'multiple model' approach; and
- the Draft Guideline doesn't provide any real guidance, and therefore, certainty, to stakeholders regarding how the AER is likely to estimate the allowed return on equity (and therefore the overall rate of return) in future revenue determinations. That is, it doesn't function effectively as a guideline.

The Draft Guideline proposes to use the Sharpe-Lintner CAPM as the foundation model for assessing the return on equity. A number of other types of evidence are ascribed particular secondary roles, either bearing on the selection of a point within the range for a particular Sharpe-Lintner parameter or acting as a 'reasonableness' check on the overall return. The evidence bearing on the selection of a point within parameter ranges includes three of the four alternative return on equity models proposed by the ENA as part of its 'multiple model' approach.

TransGrid is concerned that the foundation model approach 'shoehorns' the alternative models into limited roles for which they were not designed. Prejudging the application of the models in this way makes it more likely that they will (effectively) be given less weight in estimating the allowed return on equity than would be the case were they allowed to operate as intended, namely, to generate standalone estimates which, in the present context, could then be compared with that provided by the Sharpe-Lintner CAPM. This latter approach would be consistent with the multiple model methodology proposed by the ENA which TransGrid continues to prefer.

The issue is whether the AER's foundation model approach will operate in practice in a manner that allows for appropriate regard to be had to all the relevant evidence in accordance with the

¹ For example, National Electricity Rules cl 6A.6.2(c).

² Rules cl 6A.6.2(e)(1).

³ Rule Determination, National Electricity Amendment (Economic Regulation of Network Service Providers) Rule 2012 and National Gas Amendment (Price and Revenue Regulation of Gas Services) Rule 2012, p 57.

requirements of the Rules. One way to test this concerns the width of the ranges that the AER assesses for the relevant Sharpe-Lintner CAPM parameters. If the regulator's approach leads to narrow ranges which, in combination, result in a return on equity estimate significantly higher or lower than the estimates provided by the alternative models properly applied, and this discrepancy is not otherwise explained by the AER, then it is reasonable to conclude that the regulator's approach doesn't satisfy the Rules requirement.

The AER doesn't appear to have undertaken this test. Neither the Draft Guideline nor accompanying explanatory statement indicate the likely widths of the individual parameter ranges or resulting final overall return on equity range based on, for example, recent indicative data. This is despite the considerable material provided by the ENA in its submission that could be used for this purpose.

TransGrid doesn't expect perfect certainty in terms of how the overall return on equity allowance is likely to be calculated. The AEMC has made it clear⁴, and TransGrid agrees, that adopting a mechanistic approach is not appropriate. This is because the process of determining the allowed rate of return must be flexible enough to adapt to the circumstances arising in each individual reset process including, for example, prevailing market conditions and the availability and quality of data. However, consistent with the second sentence of the AEMC quote set out above, the Guideline must demonstrate with *reasonable* certainty how the AER's preferred methodology will be applied in practice. Without this information, stakeholders cannot be confident that the regulator's approach is:

- appropriate in terms of meeting the Rules requirement to have regard to all the relevant evidence and so satisfy the allowed rate of return objective; or
- even if it is the case that the AER's preferred methodology does operate in a manner that permits regard to be had to all the relevant evidence, that it does so in a way that is preferable to the ENA's 'multiple model' approach.

More broadly, if the Guideline doesn't set out in a transparent, predictable and replicable way how the AER's foundation model is likely to be applied in practice, then it also fails to function as a guideline. That is, it won't satisfy the policy objective reflected in the first sentence of the AEMC quote above that it 'provide service providers and other stakeholders with an ability to make a good estimate of the rate of return for particular businesses at particular points in time'. Instead, its failure to do so will increase regulatory risk for both customers and shareholders. By contrast, and for the reasons set out in the ENA's submission in response to the Draft Guideline, the multiple model approach provides much greater guidance (and therefore certainty), is more transparent and straightforward to apply and should lead to outcomes more consistent with the Rules requirements and policy objective.

An inconsistent approach

As previously submitted, TransGrid supports the position that the AER estimate the allowed return on equity principally by reference to evidence regarding the expected market return on equity rather than assess the risk free rate and market risk premium parameters under CAPM models separately and on different bases.

TransGrid notes that the Draft Guideline proposes continuing with the latter approach. However, it also proposes to use the Wright model as a 'crosscheck' on the reasonableness of that foundation model estimate. Exactly how it will use the Wright model in this way is unclear. However, the more important issue is how the AER reconciles these two approaches. The underlying premise of the Wright model is that the risk free rate and the market risk premium are perfectly inversely correlated and so must, under that model, be generated on a consistent basis. This isn't the case under the AER's proposed application of the Sharpe-Lintner model which uses a forward looking 'spot' rate to estimate the risk free rate but which may be anticipated to continue to rely primarily on a long-term historical measure to inform a 'spot' estimate of the market risk premium.

⁴ Ibid.

If the AER now agrees that the Wright model, based on a more stable long-term estimate of the return on the market, is reasonable, this begs the question why the regulator considers its approach to generating the two CAPM parameters on different bases provides the appropriate starting point for estimating the return on equity. TransGrid submits that this approach shouldn't be used to establish a default estimate. Rather, the AER should, consistent with the Rules requirements to have regard to all the evidence, equally consider taking into account those models that reflect the more stable expected market return on equity including:

- the use of a longer-term risk free rate proposed by Networks NSW; and
- the approach of market practitioners who explicitly adjust the Sharpe-Lintner CAPM outcomes for changes in market conditions such as the current historically low interest rates.

Doing so would also ensure greater consistency with the assessment of the allowed return on debt and, all things being equal, reduce volatility for both network business investors and customers.

Return on debt

Uniform debt transition insufficient to meet TransGrid's benchmark efficient cost of debt

The Draft Guideline proposes to adopt a trailing average cost of debt in order to manage the volatility of changing debt market conditions for the benefit of both customers and shareholders. TransGrid supports this and already uses a benchmark efficient portfolio approach to manage its debt

However, the AER's proposed uniform transition appears likely to increase volatility over the medium term for customers and shareholders of those network businesses who, like TransGrid, already use such an approach. On present trends, the cost of debt allowance under the AER's transitional model also appears likely to provide insufficient revenue to meet TransGrid's efficient debt management costs during our upcoming 2014/15 to 2018/19 regulatory control period. Based on current corporate bond yields, analysis conducted for TransGrid indicates that the shortfalls in net present value terms for a seven year and a ten year transition could be expected to be in the order of \$135 million and \$209 million, respectively⁵. TransGrid would also be likely to face significant costs to restructure its debt portfolio so that it aligned with the AER's transitional period funding model.

These outcomes appear inconsistent with the policy intent behind the recent changes to the Rules. They would also arguably be inconsistent with the rate of return objective and the National Electricity Objective (NEO) and Revenue and Pricing Principles contained in the National Electricity Law.

As previously submitted, transitional arrangements have been used in the past to ensure that regulated network businesses were able to move to the new arrangements without jeopardising their ability to provide the relevant services while at the same time avoiding significant price changes to customers. TransGrid is not in this situation and it will therefore not be appropriate to apply the uniform transition approach to TransGrid in its transmission determination. It already uses an efficient portfolio debt approach and therefore continues to advocate that an immediate transition to a trailing average cost of debt is appropriate in its case. At a minimum the Guideline should note that, in circumstances where a service provider already uses an efficient portfolio debt approach, it may not be necessary to apply the transitional arrangements.

⁵ The analysis is based on a benchmark efficient notional TransGrid debt portfolio of \$3.6 billion as at 1 July 2014 (60% gearing, no new debt) and uses the average of September 2013 Bloomberg BBB Fair Value Curve spot rates (extrapolated for the ten year tenor/transition). This generates an average rate of 6.03% for a seven year transition and 6.54% for a ten year transition and trailing averages of 7.80% and 7.54%, respectively.

The Draft Guideline set out three reasons for rejecting an immediate transition. These were that, in the absence of a uniform transition:

- a regulated network business could attempt to game the regulator by repeatedly switching between debt financing practices and so forestall the full impact of adopting any one method;
- there may be difficulties agreeing to an appropriate historical data set; and
- agreeing to averaging periods that didn't favour the regulated network business may be problematic.

The ENA, supported by TransGrid, addressed the AER's first concern in its submission responding to the Consultation Paper. The ENA explained that, if a business proposed to change its debt financing method for the upcoming regulatory control period, it would need to clearly demonstrate that the new arrangement was in fact a benchmark efficient practice and was therefore consistent with the rate of return objective, the NEO and the Revenue and Pricing Principles.

TransGrid is willing to work pragmatically to arrive at an agreed historical data set and an appropriate averaging period to address the AER's concerns in these areas. These steps should serve to address the AER's issues and so clear the way to more immediately delivering the benefits of the trailing average approach to both consumers and investors.

Should the AER decide not to provide an immediate transition for businesses that, like TransGrid, already use an efficient portfolio debt approach, then TransGrid submits that the Guideline should ensure that those business are able to recover the efficient costs of the portfolio restructure required to align with the regulator's transitional period funding model.

A seven year debt tenor is not supported by the evidence

The Draft Guideline proposes reducing the assumed debt tenor from ten to seven years. TransGrid continues to support a debt tenor of ten years for the reasons outlined in the ENA's submission, namely:

- the industry has put forward clear evidence that a ten year term continues to reflect efficient commercial practice;
- the data collated in 2009 on which the AER relies was heavily influenced both by the impact of the Global Financial Crises on debt markets and the incentives on regulated energy businesses to enter into hedging arrangements to minimise their exposure to the regulatory benchmark under the previous Rules;
- the difference between the ten and seven tenors is both material and volatile over time; and
- should a suitable third party data source for ten year yields be unavailable, there are a number of robust methodologies that can be used to reliably extrapolate from seven to ten year tenors (with TransGrid willing to work with the AER and other stakeholders in developing the most suitable approach)

The proposed approach to gamma is inconsistent with the Rules

The Draft Guideline proposes a new 'equity ownership' approach to estimating the 'gamma' parameter. This is a significant shift from recent Australian Competition Tribunal (Tribunal) and AER decisions over the past three years. However, TransGrid submits that the proposed approach should not be adopted. This is because it doesn't meet the key requirement in the Rules that gamma reflect the *value* of imputation credits.

Rather, and consistently with other cost of capital parameters, gamma should continue to be assessed using empirical data arising from real world transactions. The ENA has provided that evidence in the form of an updated SFG study that follows the methodology set out by the Tribunal.

The results of that study combined with accepted measures of the distribution rate result in the conclusion that the current best estimate of gamma remains unchanged at 0.25.

Process shortcomings may jeopardise the Final Guideline

Earlier in the guideline development process, TransGrid submitted that transparent and constructive engagement between the AER, industry and other stakeholders would be essential to ensure that the regulator delivers a robust guideline that meets the requirements of the Law and the Rules within the tight timeframe required. Doing so 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 shortly thereafter.

While some aspects of the development process have been positive, TransGrid considers that the AER's engagement to date has fallen short of what would be considered adequate in the circumstances. For example, TransGrid notes that, despite requests from the ENA on behalf of industry to engage early on issues of significance, the AER:

- didn't at any time prior to publishing the draft guideline indicate its intention to depart significantly from the approach to calculating gamma that the regulator has used since the Australian Competition Tribunal determined the value of gamma at 0.25 in May 2011;
- published the final Frontier Economics risk report in a timeframe that didn't allow stakeholders the opportunity to respond to it prior to release of the draft guideline;
- has not explained how the ACCC Regulatory Development Branch paper on the market risk premium should be taken into account as part of the AER's guideline development process;
- *still* has yet to publish the equity beta analysis report — this critical CAPM parameter is strongly interlinked with other key aspects of the task of assessing the return on equity. While TransGrid understands that there may be personal reasons why the AER's consultant has been unable to provide the report on time, it reinforces the concern that the regulator has been ineffective in managing the process. This has left stakeholders (at the time of writing) with an entirely unsatisfactory opportunity to respond to the beta paper; and
- failed to convene (or respond to follow up requests to do so) a number of meetings between its staff and industry representatives to progress key issues in a timeframe that would allow the outcomes from those conversations to properly inform the AER's deliberations.

Just as significantly, the contents of both the Draft Guideline and explanatory statement suggest that the AER has not considered elements of the material provided in the ENA's submission in response to the Consultation Paper. TransGrid understands that this matter is taken up further in the ENA's submission on the Draft Guideline. One consequence of the above may be that the AER will need to engage in a more detailed examination of cost of capital issues in individual determinations than it otherwise would have been required to because matters that could have been properly ventilated and considered as part of the guideline process have not been.

Overall, TransGrid considers that the AER's approach to date has negatively impacted the regulator's ability to properly take into consideration, and make informed decisions regarding, the positions and evidence put forward by industry and, potentially, other stakeholders. TransGrid remains deeply concerned that, unless this issue is addressed, the regulator's Final Guideline may not reflect appropriate standards of administrative decision-making and also fall short of meeting the Rules requirements and policy objectives for the Guideline to the detriment of one or more stakeholders. As noted above, these matters may mean that more work will need to be done by stakeholders and the AER in individual determination processes to ensure that the determination of the allowed rate of return is consistent with the requirements of the Rules. This is because the guidelines themselves, at least in their current form, are unlikely to be able to be confidently relied upon to deliver this outcome.