# EXTERNAL MEMORANDUM

**To:** Cost of Capital Subgroup
**Energy Networks Association**

**From:** Nicolas Taylor/Danielle Mathiesen

**Ref:** 580219 - 600001

**Date:** 26 September 2013

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**Subject:** **Application of the decision in the *Envestra* case to the proposals in the Australian Energy Regulator's draft *Rate of Return Guideline***

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In its draft *Rate of Return Guideline* and *Explanatory Statement*, the Australian Energy Regulator (AER) proposes to use an independent third party data service provider where available and where the method for estimating the return on debt is transparent, at present, the only such source is provided by the Bloomberg service.

In the past there has been controversy over whether such a source should be solely used or whether it is appropriate to select a bond or use a selection from the over-all population of bonds of the relevant BBB+ credit rating.

Attached to the draft *Rate of Return Guideline* is a report titled "*AER – Debt Risk Premium Expert Report"*" by Mr. Paul Bide and Mr. Michael McAlary of Chairmont Consulting Pty Ltd (Chairmont).[1] That report suggests that the following Principles should be applied by the AER for selecting the appropriate debt proxy from the market:

- **Principle 1**: The industry and entity specific characteristics of the issuer should be reflected in the industry and entity characteristics of the proxy;
- **Principle 2**: Debt structure and seniority and other key features of the debt being benchmarked should be reflected in the key features of the debt proxy; and
- **Principle 3**: The proxy bonds chosen should have risks perceived similarly in capital markets to the risks to the debt being benchmarked. The benchmarking process should seek to deliver results consistent with one undertaken by market practitioners in capital markets reflecting their perception of risk relating to the potential proxy bonds.

Further, we observe that this report was prepared for the AER on a 'commercially-in-confidence' basis:

> "*to be tabled at the Australian Competition Tribunal*"[2],

as set out in the report's terms of reference.

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[1] P Bide and M McAlary, Chairmont Consulting, '*Debt Risk Premium Export Report*', copyright 2011 and dated 9 February 2012 (final version).
[2] Ibid, page 3.

The Chairmont report was prepared in 2011 and its finalisation coincides with *Application by Envestra Limited (No. 2)* [2012] ACompT 4 (11 January 2012), (the *Envestra* case). The report was either specifically prepared for that case or would have been taken into account in the AER's submissions to the Tribunal.

Although the draft *Rate of Return Guideline* do not explicitly propose to apply these Principles, the Chairmont report has been referred to by Mr. Martin Lally in his report titled "*Estimating the Cost of Debt of the Benchmark Efficient Regulated Energy Network Business*" dated 16 August 2013 which, in turn, is relied upon by the AER in several respects.

We are asked whether the Principles set out in the Chairmont report might be used by the AER in future decisions applying the *Rate of Return Guideline*. Indeed, Chairmont's website[3] refers to a report of the same title as follows:

> "***Chairmont produced a confidential report*** *that had major implications for [Government - Industry Regulator] sector*",

titled,

> "***Debt Risk Premium Benchmarking***",

additionally,

> "*The report* ***detailed a benchmarking process*** *for identifying corporate bonds, infrastructure bonds and comparable proxies which was* ***not consistent with the client's current valuation approach***",

and,

> "*The report identified a number of practical difference between theory and market practice for determining an appropriate benchmarking process and henceforth correct valuation of debt risk premiums…****As a consequence of the report, the client has updated their benchmarking process***",
>
> (emphasis added).

In relation to establishing an allowance for the cost of debt, the current National Electricity Rules (NER) and National Gas Rules (NGR) require[4]:

> "*The allowed rate of return is to be determined such that it achieves the allowed rate of return objective"*[5]*…*
>
> *"The allowed rate of return objective is that the rate of return for a 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 service provider in respect of the provision of reference services (the allowed rate of return objective)"*[6]*…*
>
> and,

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3 Chairmont's website, see: http://www.chairmont.com.au/casestudies/debt-risk-premium-benchmarking.

4 NGR (version 18).

5 Rule 87(2) NGR (version 18).

6 Rule 87(3) NGR (version 18).

> "*In determining the* allowed rate of return*, regard must be had to:*
>
> *(a) relevant estimation methods, financial models, market data and other evidence;*
>
> *(b) the desirability of using an approach that leads to the consistent application of any estimates of financial parameters that are relevant to the estimates of, and that are common to, the return on equity and the return on debt; and*
>
> *(c) any interrelationships between estimates of financial parameters that are relevant to the estimates of the return on equity and the return on debt.*"[7]

Although the above rules have not been the subject of judicial determination, previous equivalents have been. Just before the adoption of the above rules, the previous gas rules provided:

> "*In determining the rate of return on capital it is to be assumed that the service provider meets benchmark levels of efficiency and uses a financial structure that meets benchmark standards as to gearing and other financial parameters for a going concern and reflects in other respects commercial best practice.*"[8]

In our view the new wording is not different in substance to the previous gas rules. In particular, an expectation that the service provider "*meet benchmark levels of efficiency and uses a financial structure that meets benchmark standards as to gearing and other financial parameters for a going concern and reflects in other respects commercial best practice*" uses several identical words and is equivalent to "*commensurate with the efficient financing costs of a benchmark efficient entity with a similar degree of risk*".

The Tribunal's findings in the *Envestra* case varied the AER's original determination of the DRP. In doing so, the Tribunal stated the following:

> "*The regulatory regime, in determining allowable revenue, is structured on the basis of attempting to simulate a benchmark efficient service provider. Recourse to the actual cost of debt, in seeking to defend the reasonableness of the decision, is inappropriate in this context. The reasonableness or otherwise of a component of allowable revenue must be determined on the basis of the factors set out in the NGR*."[9]

That is clearly also the intent of the wording of the new rules' use of the concept of financing costs that are "*commensurate with the efficient financing costs of a benchmark efficient entity*".

Therefore cases that have applied the previous gas rules continue to stand as good law today and should continue to be applied. Such cases include:

- *Application by Jemena Gas Works (NSW) Ltd (No 5)* [2011] ACompT 10 (the *Jemena* case);
- *ActewAGL Distribution* [2010] ACompT4 (the *ActewAGL* case); and
- the *Envestra* case.

We are not aware of any change in facts and relevant opinion evidence since the material referred to in the *Envestra* case which is the most recent of the three cases.

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7 Rule 87(5) NGR (version 18).

8 Rule 87(2)(a) NGR (version 17).

9 *Application by Envestra Limited* (No. 2) [2012] ACompT 4 (11 January 2012), paragraph 114.

In the *Envestra* and *ActewAGL* cases, the Tribunal determined that when using a sample of bonds to check the reliability of a fair value curve, the sample should be as large as possible (*Envestra* case, paragraph 92; *ActewAGL* case, paragraph 39).

In relation to BBB+ rated corporate debt and its continued use as a benchmark for determining DRP, the Tribunal stated:

> "…*it is not reasonable for [the AER] to pick and choose which of the BBB+ bonds it deems to be appropriate without considering the significance of other potentially relevant bonds*"[10],

and,

> "*that the industry of the issuer is irrelevant within the current structure of the AER's process*"[11].

This broad range of bonds is also the starting point for establishing the proxy itself. In all three of the cases referred to above, the Tribunal ruled that any deviation from a simple average of all the bond data of the relevant credit rating required a scientific basis (*Envestra* case, paragraph 106).

As noted above, the Chairmont report proposes three Principles that would deviate from including all the relevantly rated bonds on an equal basis. However, as disclosed on the Chairmont website and the substance of the arguments before the Tribunal, this report was already part of the AER's approach and the approach was reviewed and rejected by the Tribunal in the *Envestra* case. As such, the methodology adopted by the AER applying Chairmont's work did not provide an adequate scientific basis acceptable to the Tribunal for the AER to depart from the simple average of all bond data of the relevant credit rating. For the reasons set out above, the report continues to fall short of the standard required by the Tribunal before the AER can move away from using the simple average of all bond data of the relevant credit rating.

Further we note the following two points:

Firstly, even if this issue had not been settled by the previous cases, the Chairmont report is merely annexed to the *Explanatory Statement* because Mr. Lally references two of Chairmont's graphs and there is no proposal to seek to resurrect its three Principles and this could not be done without consultation. We are also curious as to a reference to a Chairmont report of 2013. This does not appear to be a typographical error referring to the 2012 report because the quoted words do not appear in the 2012 report by the same consultant.[12] Similarly, if the AER were to adopt another work by Chairmont, it would not be appropriate to update the AER's debt cost benchmarking process without transparent consultation.

Secondly, in the *Envestra* case the Tribunal noted that:

> "*The Tribunal, of course, accepts that in the first instance it is for the AER to determine whether to rely upon the Bloomberg curve, or to accept the extrapolation of that curve in the manner done in the past. It is not obliged to do so, although given the past regulatory decisions it may be expected to do so unless there were sound reasons to depart from that practice. For the future, that is a matter for the AER*.

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10 *Application by Envestra Limited* (No. 2) [2012] ACompT 4 (11 January 2012), paragraph 98.

11 *Application by Envestra Limited* (No. 2) [2012] ACompT 4 (11 January 2012), paragraph 98.

12 *We sought to contact the AER on 24 September 2013 to make further enquiries and no response was forthcoming.*

*In the longer term, as the Tribunal has said, it is open to the AER to adopt a different methodology. Consideration of the proper composition of the comparison sample of bonds, the methodology for deciding on the appropriate sample of bonds and the relevance of these bonds to its task should be undertaken by the AER in consultation with interested parties across the spectrum of entities in the industries it regulates, consumers of their services and other interested parties*."

The suitable process for a broad based consultation with interested parties across the full spectrum of entities in the industries it regulates, consumers of their services and other interested parties is the triennial rate of return guideline setting process. These triennial processes enable all parties nationally to participate on an equal footing. It is now too late to do this effectively in the 2013 Guideline process.

Regards


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