WACC Review

Response to Draft Determination – 2018 Weighted Average Cost of Capital

31 May 2019

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1 Introduction

Arc Infrastructure Pty Ltd (**Arc**) welcomes the opportunity to respond to the *Draft Determination – 2018 Weighted Average Cost of Capital at 30 June 2018 (for the Freight and Urban Networks and the Pilbara Railways)* as published by the Economic Regulation Authority (**ERA)** in May 2019 (**Draft Determination**)*.*

The following submission is structured to align with the Draft Determination and provide further commentary in relation to the calculation of Debt Risk Premium and Value of Imputation Credits (Gamma). Arc does not propose to provide further comments in respect of the balance of the Draft Determination.

Where a term is capitalised in this submission the definition of that term is consistent with the definition provided in the Draft Determination.

2   Market Risk Premium

Arc supports the view that it is unwise to constrain the Market Risk Premium in the short term, as this does not lead to an outcome consistent with achieving the average market return over the long run[1]. Arc submits that the ERA should have due regard to the Wright approach. The Wright approach has historically informed the ERA's determinations regarding market risk premium and is currently a method supported by the Queensland Competition Authority in determining market risk premium[2].

Arc's view is that deficiencies perceived by the ERA in applying the Wright approach are overstated, and in some cases, not true deficiencies. When the Wright approach is used in conjunction with the Ibbotson and DGM approaches, the resulting market risk premium estimate is robust.

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[1] *Atco Gas Final Decision*, Economic Regulation Authority, at para 1173.
[2] *Aurizon Network's 2017 Draft Access Undertaking*, Queensland Competition Authority, December 2018.

3   Value of Imputation Credits (Gamma)

A Gamma of 0.25 has been widely proposed by various Australian regulated network businesses as an appropriate approximation for the value of imputation credits. Arc's prior submission provided economic and financial theories in support of a Gamma value of 0.25. Whilst Arc's view is that a Gamma of 0.25 remains appropriate, Arc does not propose to repeat its prior submissions on that matter herein, but rather to respond to the position put forward by the ERA in the Draft Determination.

Arc recognises that the ERA is minded to adopt a Gamma of 0.5. A Gamma of this value significantly exceeds the gamma values historically adopted in Australia. The ERA's methodology departs from methodologies used by other Australian regulators and is inconsistent with the ERA's past accepted methodology.

Arc's view is that where the ERA is not prepared to accept Arc's prior submissions on Gamma, the ERA should act in a manner consistent with other Australian regulators, and adopt a Gamma value of 0.4. The ERA should take into account recent regulatory decisions and current accepted and tested methodology when determining Gamma.

In responding to the Draft Determination, Arc submits that:-

- there is no evidence that the distribution rate has markedly increased in recent years;

- The assumption that a company will distribute all franking credits is not consistent with commercial reality[3], the distribution rate in practical terms is less than 1;

- the perceived deficiencies in the ATO data are not so significant that the ERA should abandon utilising this data altogether. Other Australian regulators continue to rely on ATO data[4];

- it is incorrect for the ERA to wholly disregard the dividend drop off approach estimates and the equity ownership estimates based on ATO data, the ERA should have regard to the estimates provided by these methods;

- the distribution rate should be calculated consistently with past ERA methodology and with regard to the methodology adopted by Australian regulators; and

- the ERA should consider all of the evidence available to it and use its discretion to determine that the distribution rate should remain at 0.7 and gamma at 0.4.

3.1   Calculation of Gamma

It is widely accepted that gamma does not have an observable value. Regulators are required to use their discretion when arriving at an appropriate gamma value, having regard to various methods for estimating the distribution rate and utilisation

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[3] *Review of WACC Parameters ETSA Price Reset*, Gilbert + Tobin 22 June 2009.
[4] *Final Decision AusNet Services Transmission Determination 2017-2022 (Attachment 4- Value of Imputation Credits)*, Australian Energy Regulator, April 2017.

rate. Gamma is intended to reflect the take up rate and value of imputation credits in an Australian domestic market, it can only be estimated by reference to a series of data points from which inferences can be drawn.

The accepted methodology to determine Gamma is by application of the Monkhouse formula (distribution rate x utilisation rate). Prior to the ERA's Draft Determination, the distribution rate was widely and consistently accepted by Australian regulators as being 0.7. Prior examination has shown that there is no evidence that directly supports a distribution rate exceeding 0.7[5]. By contrast, there is no commonly agreed approach to determining the utilisation rate. Australian regulators typically have regard to the equity ownership approach (using all equity, listed equity, and ATO data as alternate inputs) and the dividend drop off approach. Typically, the resulting Gamma is described as falling within a range of values, with the regulator using their discretion to determine the final Gamma value, having regard to all of the evidence available.

3.2   Distribution Rate

The ERA intend to adopt a new approach proposed by Lally in determining the Distribution Rate input for the calculation of Gamma. The approach advised by Lally relies on data from top 50 ASX listed companies, manually adjusted to remove companies with foreign operations. Analysis undertaken of distribution rates amongst ASX listed firms provided a distribution rate of 0.83 for the top 20 ASX listed firms, 0.89 for the top 50 ASX listed firms, and 0.95 for top 50 ASX listed firms with minimal foreign operations.

The ERA have proposed using a distribution rate of 0.95. This is inconsistent with the distribution rate previously accepted by the ERA and generally accepted by the Australian Energy Regulator (**AER)**. The distribution rate is artificially increased using the Lally approach by excluding firms with foreign operations from the data set.

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[5] *Application by Energex Limited (Gamma) (No 5)* [2011] ACompT 9.

Table 1 – Gamma, Equity Ownership Approach[6]

	Distribution Rate	Utilisation Rate	Gamma
Equity Ownership Approach	0.70	0.61 – 0.70	0.43 – 0.49
Equity Ownership approach as at Sept 2017 (ABS data)	0.70	0.65	0.45
Equity Ownership Approach (Lally Estimate)	0.83	0.61 – 0.70	0.51 – 0.58
Equity Ownership Approach (Lally distribution rate)	0.83	0.65	0.54
ATO data	0.7	0.5	0.35
ATO data (Lally distribution rate)	0.83	0.5	0.41

3.3 Review of Regulatory Decisions

It is common ground that the calculation of Gamma has been subject to a number of recent reviews in Australian regulatory decisions. In particular, the calculation of Gamma featured in the Federal Court review concerning *Jemena Gas Networks*[7].

Jemena Gas Networks

On 3 June 2015 the AER made a determination in respect of Jemena Gas Network's 2015 – 2020 regulated access arrangement. Jemena Gas Networks (JGN) appealed that determination in the Australian Competition Tribunal (ACT). Following a decision by the ACT to overturn parts of the original determination, the AER appealed the ACT's decision in the Federal Court. The Federal Court handed down its decision in March 2017. One aspect of the determination subject to review was the determination of Gamma. In May 2017 the AER published its final decision in relation to the determination of Gamma, where the AER determined that a Gamma of 0.4 was appropriate and applicable.[8]

3.4 AER's Approach to Gamma

The AER have previously rejected the suggestion by Lally that a Gamma of 0.5 is appropriate[9]. The AER found that a Gamma of 0.4 was consistent with their past decisions and appropriate when all of the available evidence was duly considered. The AER further found that it was appropriate to use both the ATO statistics and the approach preferred by Lally to inform their decision. The AER formed the view that it was not inconsistent to use both approaches to inform their decision on the value of Gamma.

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[6] *Final Decision AusNet Services Transmission Determination 2017-2022 (Attachment 4- Value of Imputation Credits)*, Australian Energy Regulator, April 2017.

[7] *Applications by Public Interest Advocacy Centre Ltd and Ausgrid [2016] ACompT 1 (ACT 1 of 2015, ACT 4 of 2015) (Ausgrid); Applications by Public Interest Advocacy Centre Ltd and Endeavour Energy [2016] ACompT 2 (ACT 2 of 2015, ACT 6 of 2015); Applications by Public Interest Advocacy Service Ltd and Essential Energy [2016] ACompT 3 (ACT 3 of 2015); Application by ActewAGL Distribution [2016] ACompT 4 (ACT 5 of 2015) (together NSD 415 of 2016, NSD 416 of 2016, NSD 418 of 2016 and NSD 419 of 2016); and Application by Jemena Gas Networks (NSW) Ltd [2016] ACompT 5 (ACT 8 of 2015) (NSD 420 of 2016).*

[8] *Final Decision Jemena Distribution Determination 2016 to 2020, Attachment 4 – Value of Imputation Credits,* Australian Energy Regulator, May 2016.

[9] *Final Decision AusNet Services Transmission Determination 2017-2022 (Attachment 4- Value of Imputation Credits)*, Australian Energy Regulator, April 2017 at 14.

3.5 Conclusion

Despite perceived deficiencies in ATO data, Arc submits that:-

- the ATO data should be used to provide a check and balance against the Lally method;
- the ERA should have regard to the dividend drop off method; and
- the ERA should give due consideration and appropriate weight to the estimates provided by the dividend drop off method and equity ownership approach using ATO data, these estimates should inform the Gamma determined by the ERA; and
- the ERA should follow the approach endorsed by the AER in the AusNet determination and use its discretion to reject the Gamma value of 0.5.

Having regard to all of the evidence, Arc submits that it is appropriate to assume a distribution rate of 0.7, utilisation rate of 0.5 - 0.6 and a resultant Gamma of 0.4.

Arc's view is that varying from past accepted methodology to the degree currently proposed introduces an unacceptable degree uncertainty in the regulatory landscape. The proposed method for determining the distribution rate has not found wide spread support amongst Australian regulators, and issues identified by other economists and regulators with the Lally methodology have not been resolved. Arc urges the ERA to reconsider its position in relying solely on the Lally method.

4 References

1. *Application by Energex Limited (Gamma) (No 5)* [2011] ACompT 9.

2. *Applications by Public Interest Advocacy Centre Ltd and Ausgrid* [2016] ACompT 1 (ACT 1 of 2015, ACT 4 of 2015) *(Ausgrid); Applications by Public Interest Advocacy Centre Ltd and Endeavour Energy* [2016] ACompT 2 (ACT 2 of 2015, ACT 6 of 2015)*; Applications by Public Interest Advocacy Service Ltd and Essential Energy* [2016*] ACompT 3 (ACT 3 of 2015); Application by ActewAGL Distribution* [2016] ACompT 4 (ACT 5 of 2015) (together NSD 415 of 2016, NSD 416 of 2016, NSD 418 of 2016 and NSD 419 of 2016)*; and Application by Jemena Gas Networks (NSW)* Ltd [2016] ACompT 5 (ACT 8 of 2015) (NSD 420 of 2016).

3. *Atco Gas Final Decision*, Economic Regulation Authority.

4. *Aurizon Network's 2017 Draft Access Undertaking*, Queensland Competition Authority, December 2018.

5. *Final Decision AusNet Services Transmission Determination 2017-2022 (Attachment 4- Value of Imputation Credits)*, Australian Energy Regulator, April 2017.

6. *Final Decision Jemena Distribution Determination 2016 to 2020, Attachment 4 – Value of Imputation Credits,* Australian Energy Regulator, May 2016.

7. *Review of WACC Parameters ETSA Price Reset*, Gilbert + Tobin 22 June 2009.