ERA Secretariat Workshop on Approaches to Estimating the Cost of Equity and Debt

Summary of points

Date & Time: Thursday 7 November 2013 from 10am to 4pm

Venue: Level 4, Albert Facey House, 469 Wellington Street, Perth

The ERA Secretariat Workshop addressed approaches to estimate the return on debt and equity for the Rate of Return Guidelines for gas transmission and distribution pipelines (Guidelines). The return on debt session was focussed on a background paper prepared for the Secretariat by the Chairmont Group. The Secretariat had prepared a separate background paper for the return on equity session with a proposed approach to estimate the return on equity for gas transmission and distribution pipelines. This summary should be read together with these background papers.

A range of stakeholders participated in the workshop, including representatives of:

- regulated energy businesses; and
- State authorities.

This summary outlines the key outcomes of the workshop, including views expressed, without ascribing particular comments to any one individual or organisation. At the conclusion of the Workshop, the Secretariat encouraged participants to provide a written submission prior to the closing date.

Return on Debt

- Stakeholders questioned Section 4.1 Objectives and Section 4.2 Constraints in the background paper prepared by Chairmont. Stakeholders suggested that some objectives are contradictory. Stakeholders also questioned the appropriateness of ruling out, in the objectives, the use of the trailing average approach, and noted that one of the objectives, NPV=0, should be stated as NPV ≥ 0.
- Stakeholders suggested the Chairmont report needed to be clear about the extent to which the Secretariat had delineated the objectives for the Chairmont assessment. The Secretariat noted that it had workshopped the objectives with Chairmont, using the ERA's objectives from the draft rate of return guidelines as a starting point.
- The difference between the AER's approach of using a trailing average and the ERA's approach in the Draft Guidelines of using an annual update was discussed. Stakeholders questioned how different approaches could result from applying the same rate of return objective in the National Gas Rules. The Secretariat noted that each regulator may use different assessment weightings to arrive at different approaches.
- Stakeholders suggested that the trailing average approach should not be excluded from the Guidelines and that regulated firms should be given the option to use either an annual update or trailing average approach. A Stakeholder noted that it was customers who had originally proposed the rule change to allow the trailing average approach.
- There was no consensus by Stakeholders on which approach was generally preferred by regulated businesses, although most regulated businesses appeared to prefer the trailing average approach. One Stakeholder said that the trailing average approach

was the only approach it could feasibly attempt to replicate in undertaking financing activities, due to the size of its debt issuance.

- There was discussion on why the length of the regulatory period has an effect on the efficient financing costs, particularly considerations relating to the term of debt.
- Concerns were raised that the annual updating approach would lead to price volatility for customers within a regulatory period rather than just between periods, and that views should be sought from customers to see whether they are willing to accept price volatility annually compared to every 5 years.
- The Secretariat noted that an annual update could help businesses to raise debt during periods such as the Global Financial Crisis.
- Issues were raised about the term to maturity of debt. There was discussion on whether the ERA should base the return on debt on the average term to maturity, or on the average issuance period. The Secretariat suggested that both a new entrant and an incumbent would need to stagger debt.
- Stakeholders noted that the Queensland Treasury Corporation had assessed whether there was any degree of bias in either the prevailing rates or trailing average approaches to estimating the return on debt. It was also noted that this work examined the time it took under each approach for any ‘under’ or ‘over’, comparing the regulated rate to the actual rate, to be recovered.

Return on Equity

- The workshop discussed definitions of the terms 'estimation method' and 'financial models'. In addition, the term 'approach' was canvassed as an overarching description for a means to determine the return on equity that utilised a particular set of 'material' (the latter reflecting relevant estimation methods, financial models, market data and other evidence).
- The 5 step approach proposed in the background paper for the return on equity was considered potentially workable, although some caveats were expressed.
- Stakeholders suggested that the primacy of the allowed rate of return objective needed to be emphasised as a final step 6.
- Stakeholders suggested that Step 1 should outline what might be considered consistent with the allowed rate of return. In this context, it was suggested that any approach could be tested against the allowed rate of return objective, by observing the degree to which it could predict the rate of return of any firm in the economy.
- Stakeholders were concerned that the worked example in the Secretariat paper was too narrow - in terms of the 'material' considered relevant. In response, the Secretariat emphasised that stakeholders could consider the extent to which the 5 step approach was able to handle any combination of relevant material (including in the event that multiple financial models were considered relevant).
- There was discussion of what is meant by a range, how ranges would be established, and how multiple ranges could be combined. It was noted that there may be a need for flexibility in the methods used to combine ranges, as relevant ranges may arise from quite different types of information. It would be important for the guidelines to be clear on these interpretations.
- It was noted that the quoted confidence intervals around the historic estimates of the market risk premium relate to the average annual return (that is, reflecting 'average conditions'), not to the confidence interval of the bounds of the return in any one year.

- It was noted that the VIX only measures the amount of risk, not the price.

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