ActewAGL
for you

Mr John Pierce
Chairman
Australian Energy Market Commission,
Level 6, 201 Elizabeth Street,
SYDNEY NSW 2000

15 September 2016

Dear Mr Pierce,

Rule Change to Delay Rate of Return Guidelines Review

ActewAGL Distribution (**AAD**) welcomes the opportunity to respond to the Australian Energy Market Commission's (**AEMC's**) consultation paper on the *National Electricity/Gas Amendment (Rate of Return Guidelines Review) Rule 2016* dated 18 August 2016 (**Consultation Paper**).

AAD addresses each of the issues raised in the Consultation Paper in turn below.

In summary, AAD's preferred position is that the review deadline for the revised Rate of Return Guidelines (**Revised Guidelines**) be June 2018, rather than December 2018 as proposed by the Australian Energy Regulator (**AER**). In AAD's view, this 18 month extension should provide sufficient time for the AER to issue the Revised Guidelines and reflect them in its draft determination for AAD's ACT electricity distribution reset process for its 2019/20 to 2023/24 regulatory control period (**next RCP**), and would ensure a meaningful opportunity for AAD to consider and respond to the Revised Guidelines in preparing its revised regulatory proposal.

Notwithstanding this position, AAD notes that if the Revised Guidelines are delayed beyond June 2018, there is nothing in the proposed transitional arrangements that would prevent AAD from deviating from the current Rate of Return Guidelines (**Current Guidelines**) to reflect the outcome of current legal proceedings. Indeed, this would be necessary if the outcome of those proceedings is that the findings of reviewable error in the approach set out in the Current Guidelines are affirmed.[1]

Costs and Risks of the Proposed Solution

AAD supports the motivation for the Rule change request from the AER to extend the deadline to review the Current Guidelines given that important aspects of those Guidelines such as the approach to the return on debt transition and the estimation and

[1] To the extent that the AER could be understood to suggest the contrary in its Rule change request of 7 June 2016, in observing (at page 4) that a provider may depart from the Current Guidelines in a regulatory proposal 'if doing so would contribute to the achievement of the allowed rate of return objective', this is incorrect.

value of imputation credits (**gamma**) are currently the subject of proceedings instituted by the AER in the Federal Court for judicial review of the determinations of the Australian Competition Tribunal (**Tribunal**) in February 2016 in the NSW/ACT merits review proceedings. However, as recognised by the AEMC in its Consultation Paper, the AER's proposed solution of extending the review deadline for the Guidelines by two years, from 17 December 2016 to 17 December 2018, poses difficulties for AAD's ACT electricity distribution reset process for the next RCP.

These difficulties arise because:

- AAD's regulatory proposal for the next RCP must be submitted by the end of January 2018,[2] the AER's draft determination on AAD's regulatory proposal is currently scheduled to be made in September 2018 and AAD's revised regulatory proposal is scheduled for submission in December 2018.[3]
- Under the AER's proposed Rule change, it is likely therefore that the Current Guidelines will apply to AAD's regulatory proposal and the AER's draft determination. This is notwithstanding that:
    - the Tribunal's determinations found reviewable error in both the AER's method for transition to the trailing average approach to estimation of the return on debt and its method of estimation, and estimated value of gamma in the Current Guidelines. The Tribunal's reasons for decision in relation to the return on debt transition also have implications for the legally permissible approach to estimation of equity beta for the purpose of estimating the return on equity; and
    - it is likely that the Federal Court will rule on the AER's application for judicial review at some time in 2017 and, in AAD's opinion, it is unlikely that the outcome will be that both the AER's approach to the return on debt transition and its approach to the estimation of gamma will be affirmed.
- It is likely therefore that the regulatory proposal and draft determination will need to depart from the Current Guidelines in estimating the allowed rate of return and/or gamma as significant elements of those Guidelines have been found to be affected by reviewable error.
- The Rules require both AAD and the AER to identify departures from the then prevailing Guidelines in the regulatory proposal and draft AER determination respectively.[4] Accordingly, AAD and the AER will likely be required to identify

[2] Clause 6.8.2(b)(1) of the National Electricity Rules (**Rules**).
[3] Clause 6.10.3(a) of the Rules.
[4] Clauses 6.3.1(c)(3) and S6.1.3(9) of the Rules require that a building block proposal must contain, amongst other information, the Distribution Network Service Provider's calculation of the proposed return on equity, return on debt and allowed rate of return, for each regulatory year of the regulatory control period, in accordance with clause 6.5.2,

departures in their estimation of the return on debt, return on equity and allowed rate of return from the Current Guidelines, and to otherwise address those Guidelines (including in relation to gamma), in AAD's regulatory proposal and the AER's draft determination respectively notwithstanding that the need for those departures is the foreseeable result of errors in those Guidelines.

- Further, under the AER's proposed Rule change, either AAD will have to address the Current Guidelines in its revised regulatory proposal (if the Revised Guidelines are not published prior to the submission of that proposal) or AAD will have to address the Revised Guidelines in its revised regulatory proposal but without sufficient time to properly do so (if the Revised Guidelines are published prior to the submission of that proposal).
- Finally, the Revised Guidelines will apply to the AER's final determination notwithstanding that AAD could not adequately (or at all) consider those Guidelines in preparing its revised regulatory proposal.

The AER's Rule change proposal does not include any changes to the applicability of the Rules (such as transitional provisions) to address these issues.

As a result, under the AER's Rule change proposal, there will likely be:

- significant uncertainty for AAD given that the AER's draft determination will refer to the Current Guidelines (that do not reflect the outcome of the AER's judicial review proceedings) whereas the AER's final determination will reflect the Revised Guidelines which can be expected to differ in numerous and material respects from the Current Guidelines;
- insufficient time for AAD to properly consider the Revised Guidelines in preparation of its revised regulatory proposal, which arguably constitutes a denial of procedural fairness and is inconsistent with section 16(1)(b) of the National Electricity Law; and
- a regulatory burden on AAD, and an administrative burden on the AER, associated with identifying departures from the Current Guidelines in their regulatory proposal and draft determination respectively in circumstances where this does not result in any benefit because it is known at the time that those Guidelines are affected by reviewable error and, accordingly, will not be applied by the AER in making its determination.

The timing issues identified by the AEMC in its Consultation Paper are of significant concern to AAD for these reasons.

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including any departure from the methodologies set out in the Rate of Return Guidelines and the reasons for that departure. Clause 6.2.8(c), in turn, requires the AER, if it makes a distribution determination that is not in accordance with the Rate of Return Guidelines, to state, in its reasons for the distribution determination, the reasons for departing from those Guidelines.

Transitional provisions

For the reasons discussed above, AAD agrees with the AEMC that the AER's proposed Rule change is problematic in the absence of modification.

In considering potential modification of the AER's proposal such as transitional provisions, it is important to recognise that the Rate of Return Guidelines are intended to promote transparency and certainty as to the methodologies the AER is likely to adopt in estimating the return on equity, the return on debt and the allowed rate of return. In its 2012 Rule Change Determination, the AEMC stated that the Guidelines are not determinative of the rate of return calculation but:[5]

> *'...are more about providing service providers, investors and consumers with certainty on the methodologies of the various rate of return components and how the regulator will assess the relevant estimation methods, financial models, market data and other evidence in meeting the overall allowed rate of return objective'.*

The AEMC further indicated that it:[6]

> *'intends the guidelines to provide a meaningful signal as to the regulator's intended methodologies for estimating return on equity and return on debt components of the allowed rate of return'*

and

> *'anticipates that the guidelines would allow a service provider or other stakeholder to make a reasonably good estimate of the rate of return that would be determined by the regulator if the guidelines were applied'.*

Similarly, the AER has itself observed that the purpose of the Rate of Return Guidelines is to set out how the AER intends to determine the return that electricity and gas network businesses can earn on their investments and that, applied consistently over time, the Guidelines should provide regulatory stability and increased certainty through greater transparency of the key components of the rate of return and how these are assessed.[7]

The Current Guidelines are, however, incapable of providing the meaningful signal of the AER's intended methodologies for estimating the return on equity and return on debt that was the AEMC's stated rationale for the Rate of Return Guidelines. This is primarily because, as outlined above, the Tribunal has found that the AER's approach to the return on debt transition and estimation of gamma set out in the Current Guidelines is affected by reviewable error, and it likely also follows from the Tribunal's reasons for decision on

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[5] AEMC, *Rule Determination - National Electricity Amendment (Economic Regulation of Network Service Providers) Rule 2012; National Gas Amendment (Price and Revenue Regulation of Gas Services) Rule 2012*, 29 November 2012, page 57.
[6] As above, page 71.
[7] AER, Better Regulation fact sheet - rate of return guideline - December 2013.

the return on debt transition issue that the AER's approach to the estimation of equity beta set out in those Guidelines is affected by reviewable error.

The issues in contention in the AER's judicial review proceedings have important implications for the Revised Guidelines. In addition, the Revised Guidelines may also contain other significant changes that require AAD's careful consideration. It is therefore important that, to provide the meaningful signal of the AER's methodologies intended by the AEMC, AAD (and other stakeholders) have access to the Revised Guidelines well prior to the submission of AAD's revised regulatory proposal (and stakeholders' subsequent submissions in response to the AER's draft determination).

Accordingly, AAD's preference would be for the AEMC to extend the review deadline only to June 2018 to allow sufficient time for the Revised Guidelines to be published prior to and considered in the AER's draft determination for AAD and AAD's revised regulatory proposal. AAD considers this 18 month extension will provide sufficient time for the AER to issue Revised Guidelines that reflect the outcome of the AER's judicial review proceedings.

AAD further proposes that accompanying transitional provisions exclude the operation of the requirement under the Rules for AAD to identify departures from the Rate of Return Guidelines in respect of its regulatory proposal for the next RCP.[8] This is because AAD will otherwise incur additional regulatory costs without any associated benefit. More specifically, under AAD's proposed Rule change in the absence of these transitional provisions, AAD will likely be required to identify departures from the Current Guidelines in its estimation of the return on debt, return on equity and allowed rate of return in its regulatory proposal notwithstanding that those Guidelines have been found to be affected by reviewable error and will necessarily be departed from by the AER in decision-making.

AAD does not consider the AEMC's proposed transitional provisions would adequately address the issues identified above.

The AEMC's initial view is that the most appropriate approach is to specify that the Current Guidelines would apply to the regulatory determination processes of affected service providers. However, this approach does not satisfactorily address the issues of certainty and transparency, or the provision to AAD of an adequate opportunity to consider and comment on the Revised Guidelines that will be applied by the AER in makings its final determination, noted above. Under the AEMC's approach, the application of the Rate of Return Guidelines does not deliver the meaningful signal of the AER's methodologies that was their very rationale because the Current Guidelines are incapable of doing so. At the same time, under the AEMC's approach, AAD and the AER will still incur the regulatory and administrative costs of identifying departures from the Current Guidelines that are the consequence of the Tribunal's determinations and the outcome of the AER's judicial review proceedings. In short, the AEMC's proposed

[8] This requirement is imposed by clause S6.1.3(9) of the Rules.

transitional provisions deliver none of the intended benefits of the Rate of Return Guidelines while still imposing the regulatory and administrative costs of addressing those Guidelines in the regulatory determination process.

Should you have any queries, please contact Alexis Hardin, Manager Regulatory Finance and Strategy, 02 6248 3033, alexis.hardin@actewagl.com.au.

Yours sincerely

David Graham

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